

**MODERNIZING CONSUMER PROTECTION IN THE
FINANCIAL REGULATORY SYSTEM: STRENGTH-
ENING CREDIT CARD PROTECTIONS**

HEARING
BEFORE THE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
ONE HUNDRED ELEVENTH CONGRESS
FIRST SESSION
ON
REFORMING THE PRACTICES OF CREDIT CARD COMPANIES AND
PROVIDING NEW PROTECTIONS FOR CONSUMERS

FEBRUARY 12, 2009

Printed for the use of the Committee on Banking, Housing, and Urban Affairs



Available at: <http://www.access.gpo.gov/congress/senate/senate05sh.html>

U.S. GOVERNMENT PRINTING OFFICE

50-815 PDF

WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2104 Mail: Stop IDCC, Washington, DC 20402-0001

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

CHRISTOPHER J. DODD, Connecticut, *Chairman*

TIM JOHNSON, South Dakota	RICHARD C. SHELBY, Alabama
JACK REED, Rhode Island	ROBERT F. BENNETT, Utah
CHARLES E. SCHUMER, New York	JIM BUNNING, Kentucky
EVAN BAYH, Indiana	MIKE CRAPO, Idaho
ROBERT MENENDEZ, New Jersey	MEL MARTINEZ, Florida
DANIEL K. AKAKA, Hawaii	BOB CORKER, Tennessee
SHERROD BROWN, Ohio	JIM DEMINT, South Carolina
JON TESTER, Montana	DAVID VITTER, Louisiana
HERB KOHL, Wisconsin	MIKE JOHANNES, Nebraska
MARK R. WARNER, Virginia	KAY BAILEY HUTCHISON, Texas
JEFF MERKLEY, Oregon	
MICHAEL F. BENNET, Colorado	

COLIN MCGINNIS, *Acting Staff Director*

WILLIAM D. DUHNKE, *Republican Staff Director*

AMY FRIEND, *Chief Counsel*

LYNSEY GRAHAM REA, *Counsel*

DREW COLBERT, *Legislative Assistant*

DEBORAH KATZ, *OCC Detailee*

JULIE CHON, *International Economic Adviser*

MARK OESTERLE, *Republican Chief Counsel*

ANDREW OLMEM, *Republican Counsel*

DAWN RATLIFF, *Chief Clerk*

DEVIN HARTLEY, *Hearing Clerk*

SHELVIN SIMMONS, *IT Director*

JIM CROWELL, *Editor*

CONTENTS

THURSDAY, FEBRUARY 12, 2009

	Page
Opening statement of Senator Dodd	1
Opening statements, comments, or prepared statements of:	
Senator Shelby	4
Senator Brown	5
Senator Akaka	6
Senator Menendez	7
Senator Schumer	7
Senator Reed	9
Senator Tester	9

WITNESSES

Adam J. Levitin, Associate Professor of Law, Georgetown University Law Center	10
Prepared statement	44
Response to written questions of Senator Shelby	215
Kenneth J. Clayton, Senior Vice President and General Counsel, Card Policy Council, American Bankers Association	12
Prepared statement	72
Response to written questions of Senator Shelby	221
James C. Sturdevant, Principal, The Sturdevant Law Firm	13
Prepared statement	96
Response to written questions of Senator Shelby	224
Todd J. Zywicki, Professor of Law, Mercatus Center Senior Scholar, George Mason University School of Law	15
Prepared statement	115
Response to written questions of Senator Shelby	226
Lawrence M. Ausubel, Professor of Economics, University of Maryland, Department of Economics	18
Prepared statement	154
Response to written questions of Senator Shelby	230
Travis B. Plunkett, Legislative Director, Consumer Federation of America	19
Prepared statement	170
Response to written questions of Senator Shelby	232

MODERNIZING CONSUMER PROTECTION IN THE FINANCIAL REGULATORY SYSTEM: STRENGTHENING CREDIT CARD PROTECTIONS

THURSDAY, FEBRUARY 12, 2009

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:10 a.m., in room 538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order. My apologies to our witnesses and my colleagues. Today is the 200th anniversary of Abraham Lincoln's birthday and I took my daughter up to Lincoln's cottage this morning up at the Old Soldier's Home where there was a ceremony this morning to unveil a wonderful statue of Abraham Lincoln and his horse Old Boy that he used to ride every morning for about a quarter of his Presidency from the White House to the Old Soldiers Home where he lived for a quarter of that Presidency and he wrote the Emancipation Proclamation. So I thought I would take my daughter out of school this morning for a bit of history and I am sorry to be a few minutes late getting back here this morning, so apologies to everybody for being a few minutes late for enjoying a moment of history with a 7-year-old.

Well, let me begin with some opening comments, if I can. I will turn to Senator Shelby. We are honored to have such a distinguished panel of witnesses with us this morning on an issue that many of my colleagues know has been a source of interest of mine for literally two decades, the issue of reform of the credit card industry. And so this hearing this morning will give us a chance to reengage in that debate and discussion, and I want my colleagues to know at some point, and I say this to my good friend, the former Chairman of the Committee, at some point, I would like to be able to mark up a bill in this area. I know he knows that, but I wanted to say so publicly.

So good morning to everyone, and today the Committee meets to look into an issue of vital importance to American consumers, their families, and to the stability of our financial system, and that is the need to reform the practices of our nation's credit card companies and to provide some tough new protections for consumers.

In my travels around my State, as I am sure it is true of my colleagues, as well, we frequently hear from constituents about the burden of abusive credit card practices. In fact, the average amount of household credit card debt in my State is over \$7,100. Actually, the number is higher, I think, nationally. Non-business bankruptcy filings in the State are increasing. In the second quarter of last year, credit card delinquencies increased in seven of eight counties in my State.

Across the country, cardholders are paying \$12 billion in penalty fees annually, every year. It is a major problem throughout our nation. At a time when our economy is in crisis and consumers are struggling financially, credit card companies in too many cases are gouging, hiking interest rates on consumers who pay on time and consistently meet the terms of their credit card agreements. They impose penalty interest rates, some as high as 32 percent, and many contain clauses allowing them to change the terms of the agreement, including the interest rate, at any time, for any reason. These practices can leave mountains of debt for families and financial ruin in far too many cases.

When I introduced Secretary Geithner earlier this week as he unveiled the framework of the President's plan to stabilize our financial system, I noted then for too long, our leading regulators had failed fully to realize that financial health and security of the consumers is inextricably linked to the success of the American economy. In fact, for too many years, I think people assumed that consumer protection and economic growth were antithetical to each other. Quite the opposite is true.

I noted that unless we apply the same urgent focus to helping consumers that we apply to supporting our banks' efforts to restart lending, we will not be able to break the negative cycle of rising foreclosures and declining credit that is damaging our economy.

In this hearing, the Committee examines abusive credit card practices that harm consumers and explores some very specific legislative ideas to end them. These kinds of consumer protections must be at the forefront of our efforts to modernize our financial regulatory system.

Why is this both important and urgent? Well, today, far too many American families are forced to rely on short-term, high-interest credit card debt to finance their most basic necessities. And as layoffs continue, home values plunge, and home equity lines of credit are cut or canceled, they are increasingly falling behind. This December, the number of credit card payments that were late by 60 days or more went up 16.2 percent from last year.

Banks increasingly worried about taking more debt, bad debt, into their balance sheets are monitoring their credit card portfolios very closely, slashing credit lines and increasing fees and interest rates even more for consumers who have held up their end of the bargain. That puts consumers, including many of my constituents and others around the country, in the worst possible position at the worst possible time.

For too long, the use of confusing, misleading, and predatory practices have been standard operating procedures for many in the credit card industry. The list of troubling practices that credit card companies are engaged in is lengthy and it is disturbing: Predatory

rates, fees, and charges; anytime, any reason interest rate increases and account charges; retroactive interest rate increases; deceptive marketing to young people; shortening the period consumers have to pay their bills with no warning. Even the Federal financial regulators, of whom I have been openly critical for a lack of appropriate oversight throughout this subprime mortgage market crisis, recognize the harm these sinister practices pose not only to credit card customers, but also to our economy.

Last May, the Federal Reserve, the Office of Thrift Supervision, and the National Credit Union Administration proposed rules aimed at curbing some of these practices. These rules were a good step and I applaud them, but they are long overdue. But they fell far short of what is actually needed, in my view, to protect American families.

Just as we have seen in this housing crisis, when companies lure people into financial arrangements that are deceptive, abusive, and predatory, it only means mountains of debt for families, bankruptcy, and financial ruin for far too many. It also proved catastrophic, of course, for our economy.

Today as the Committee examines how best to modernize and reform our outdated and ineffective financial regulatory system, we have a clear message to send to the industry. Your days of bilking American families at the expense of our economy are over. Today, we will discuss proposals to reform abusive credit card practices that drag so many American families deeper and deeper and deeper into debt, including the Credit Card Accountability, Responsibility, and Disclosure Act, which I recently reintroduced.

We must protect the rights of financially responsible credit card users so that if a credit card company delayed crediting your payment, you aren't charged for this mistake. We must prevent issuers from changing the terms of a credit card contract before the term is up. And perhaps most importantly, we must protect our young people who are faced with an onslaught of credit card offers, often years before they turn 18, or as soon as they set foot onto a college campus. These practices are wrong and they are unfair. And mark my words, in the coming months, they are going to end.

Of course, we must do all we can to encourage consumers to also act responsibly when it comes to using credit cards. But we should demand such responsible behavior when it comes to the companies that issue these cards, as well.

The need to reform credit card practice has never been more important. It is not only the right thing to do for families and our consumers, it is the right thing to do for our economy, as well. I have been working on reforms in this area for many, many years and I am determined to move forward on these reforms.

With that, let me turn to our former Chairman and Ranking Member, Richard Shelby.

STATEMENT OF SENATOR SHELBY

Senator SHELBY. Thank you, Chairman Dodd.

Although problems with mortgage-related assets have taken center stage in our ongoing financial crisis, credit card lending has also rapidly declined as our economy has deteriorated. The securitization market, a key vehicle for financing credit card transactions, remains severely constrained, at its best. The absence of a robust secondary market has deprived many financial institutions of the financing needed to support credit card-based lending. Unable to securitize their credit card portfolios, many banks have been forced to cut back their customers' credit limits or even terminate their customers' credit cards altogether.

In the midst of these challenging market conditions, the Federal Reserve, along with the Office of Thrift Supervision and the National Credit Union Administration, finalized new rules last December that will drastically alter the credit card industry. The rules prohibit a variety of business practices and impose a new layer of complex regulation. They also update and enhance certain consumer protections.

The new rules will be implemented over the next year and a half, but already, financial institutions are drastically altering their credit card practices, as they should. Recent reports suggest that the new rules will cause a substantial contraction in consumer credit.

While I believe that there are many credit card practices that need reforming, as Senator Dodd mentioned, I also believe that regulators need to be especially careful in this time of financial stress not to take actions that unduly restrict the availability of credit. Limiting the ability of consumers of low and moderate means to obtain credit could have unfortunate consequences. If they can't get credit from regulated banks, they may seek it outside the banking system. Regulators must exercise caution to ensure that the appropriate balance is struck between adequately safeguarding consumers, which is important to all of us, while not eliminating access to credit for millions of American families.

Regulators also need to make sure that they do not stifle innovation or unduly restrict consumer choice. Many innovative products that have been demanded by and have benefited consumers, including zero percent financing, may be eliminated or severely curtailed because of the recent regulatory rule changes.

We can all agree that abusive products should be addressed, and soon, but we should also be careful not to eliminate legitimate products in doing that. An overly broad approach risks giving consumers a false sense of security. Too often, consumers fail to consider whether a particular financial product is right for them because they believe that Federal regulators have already determined which products are safe and which are dangerous. Yet in many cases, whether a financial product is appropriate for a consumer depends on the consumer's own financial position. If the financial crisis has taught us anything, it is that all sectors of our economy, from big commercial banks to retail consumers, need to do more due diligence before they enter into financial transactions. No regulator can protect a consumer as much as they can protect themselves if they have the necessary information, which is why clear,

complete, and understandable disclosure, as Senator Dodd has pushed for years, is so critical.

Several bills have been introduced that seek to codify the recent rule changes, and in several instances would go beyond those rules to enact even more severe regulations. I believe before we legislate in this area, I think we should be careful. I would prefer that we give regulators the necessary time to implement the rule changes and then we can evaluate how those rules have worked and what changes are needed.

In this time of economic turmoil, we need to proceed carefully, but we do need to proceed. We need to be especially careful not to undermine the ability of our financial system to accurately price risk. The advent of risk-based pricing has helped our financial institutions expand the availability of credit. Undermining the ability of banks to employ risk-based pricing could reverse this very positive development.

As this Committee begins to consider regulatory reform, I believe it is important to keep in mind the need to balance carefully our strong desire to protect consumers and the absolute necessity of preserving an innovative and diverse marketplace. These are not mutually exclusive concepts and it is our job—our obligation—to craft a regulatory structure that can accommodate them both, and I hope we will.

Senator Johnson.

[Presiding.] The Chairman has stepped out momentarily to confer with Secretary Geithner and Mr. Summers. Does anyone want to comment briefly before we get to the panelists? Senator Reed?

Senator REED. I will pass, Mr. Chairman, and defer to my colleagues if they would like to speak.

Senator JOHNSON. Anybody?

STATEMENT OF SENATOR BROWN

Senator BROWN. Mr. Chairman, I would like to make a couple of comments. Thank you, Mr. Chairman, Senator Johnson.

I think a lot of us—I appreciate the comments both of Senator Shelby and the Chairman. A lot of us are particularly concerned about credit card targeting of young people. Go to any college campus across this country, in my State, Ohio State, the largest university in the country, you will see that college students are inundated with credit card applications. Ohio State's own Web site counsels students to, quote, "avoid credit card debt while you are a college student." We know what kind of debt students face anyway and I think that just paints the picture of how serious this is.

There are other examples of what has happened with small business and it is so important. I just underscore how important this issue is and that we move forward on more consumer protections.

I yield my time back.

Senator JOHNSON. Senator Akaka, you have a comment to make?

STATEMENT OF SENATOR AKAKA

Senator AKAKA. Yes. Thank you very much. I appreciate the Chairman holding this hearing.

Too many in our country are burdened by significant credit card debt. Not enough has been done to protect consumers and ensure they are able to properly manage their credit burden. We must do more to educate, protect, and empower consumers.

Three Congresses ago, or the 108th Congress, I advocated for enactment of my Credit Card Minimum Payment Warning Act. I developed the legislation with Senators at that time, Senators Sarbanes, Durbin, Schumer, and Leahy. We attempted to attach the bill as an amendment to improve the flawed minimum payment warning in the Bankruptcy Abuse Prevention and Consumer Protection Act. Unfortunately, our amendment was defeated.

My legislation, which I will be reintroducing shortly, requires companies to inform consumers how many years and months it will take to repay their entire balance if they make only minimum payments. The total cost of interest and principal if the consumer pays only the minimum payment would also have to be disclosed. These provisions will make individuals much more aware of the true costs of credit card debt.

The bill also requires that credit card companies provide useful information so that people can develop strategies to free themselves of credit card debt. Consumers would have to be provided with the amount they need to pay to eliminate their outstanding balance within 36 months.

My legislation also addresses the related issue of credit counseling. We must ensure that people who seek help in dealing with complex financial issues, such as debt management, are able to locate the assistance they need. Credit card billing statements should include contact information for reputable credit counseling services. More working families are trying to survive financially and meet their financial obligations. They often seek out help from credit counselors to better manage their debt burdens. It is extremely troubling that unscrupulous credit counselors exploit for their own personal profit individuals who are trying to locate the assistance they need.

My legislation establishes quality standards for credit counseling agencies and ensures that consumers would be referred to trustworthy credit counselors. As financial pressures increase for working families, credit counseling becomes even more important. As we work to reform the regulatory structure of financial services, it is essential that we establish credit counseling standards and increase regulatory oversight over this industry.

Mr. Chairman, I appreciate your inclusion of this in your bill, of a provision that mirrors the minimum payment warning provisions in my bill. Thank you very much, Mr. Chairman.

Senator JOHNSON. Thank you, Senator Akaka.

Senator Menendez, do you have a very brief statement to make?

STATEMENT OF SENATOR MENENDEZ

Senator MENENDEZ. I will make a brief statement. I don't know about very brief, Mr. Chairman. I will make a brief statement.

Senator SCHUMER. Moderately brief.

[Laughter.]

Senator MENENDEZ. Moderately brief. Let me thank the Chairman for holding this hearing. Credit card reform has been one of the top priorities that I have had both in the House and in the Senate since I arrived here, and I think this hearing couldn't come at a more important time, when millions of Americans are increasingly using their credit cards to float their basic necessities from month to month. As a result, Americans have almost \$1 trillion of credit card debt outstanding. It seems to me that it is a dangerous cycle that is piling up.

And while that debt is piling up, people in our State and across the country are discovering that their credit card agreements often conceal all kinds of trap doors behind a layer of fine print. If you take one false step, then your credit rating plummets and your interest rate shoots through the roof.

Many of my constituents have contacted me after facing sky-high interest rates they never expected after accepting one offer, only to learn later that the terms seem to have been written in erasable ink, or after watching in horror as their children in college get swallowed in debt.

So far too many people, credit card is already a personal financial crisis and I believe it is a national crisis. Our economy will not recover if debt ties down consumers tighter and tighter, and making credit card lending practices fairer would be the right thing to do under any circumstances, but under these economic conditions, it is an absolute necessity.

Mr. Chairman, I have legislation, as well. Some of it has been incorporated in what I think Chairman Dodd is going to include. I appreciate those efforts and I hope that the Federal Reserve's guidelines, which are a good step, could actually be accelerated, because waiting a year and a half to get those guidelines into place at a critical time in our economy is only buying us more and more challenges.

With that, Mr. Chairman, I ask that the rest of my statement be included in the record.

Senator JOHNSON. Senator Schumer, do you have a very brief statement?

STATEMENT OF SENATOR SCHUMER

Senator SCHUMER. I also have a moderately brief statement, like my colleague from across the Hudson River, but I thank you for calling on me. It is an issue that I have been involved with and care about for a long time.

We know how important this is. Average credit card debt for the average—the average American family has \$8,500 in credit card debt on a yearly income of \$52,000. That ought to make you stop and think right then and there.

I have been working on this issue for a long time. When I started in the 1980s, there were two schools. Some said disclosure is enough and competition would take hold. Others said, let us put

limits. I was in the former school. I said, free market, let disclosure work. I worked long and hard on legislation and the Fed and the result was something that became known as the "Schumer Box," clear, concise disclosures of important credit card terms in an easy-to-read table, and it worked.

Before the Schumer Box, credit card interest rates were at 19.8 percent. Every company somehow came up with the conclusion that was the exact right rate. There was no competition. The box came in and rates came down. Good old fashioned American competition did the job. So it worked. Disclosures at that point seemed to be a good balance between consumer protection and fostering business and innovation.

But now, credit card companies have become so clever at inducing consumers to buy and use cards and trapping them with high interest rates and fees that I believe disclosure is no longer enough. Over the past few years, we have seen explosion of debt. The card industry began using many of the same sales tactics as mortgage brokers, below-market fees or interest rates that shoot up for the most minor of infractions, and fine print, as Senator Menendez mentioned, containing dozens of fees that a consumer has to pay.

Now, recently, the Federal Reserve updated the Schumer Box. I was glad to see that. But more has to be done. Consumers are trapped in a business model that is designed to induce mistakes and jack up fees. That sums it up. And then the fees go from 7 percent to 19 percent for some minor infraction on all the debt, something is very wrong and disclosure is not enough.

The type of trip-wire pricing is predatory. It has to end. One issuer went so far as to provide its customers with incorrectly addressed return envelopes to ensure that consumer payments wouldn't arrive on time and allowed the company then to charge late payment fees. That is outrageous. Other companies charge fees so often, so many fees so often, borrowers end up paying over the limit fees because their credit has been maxed out by the previous round of fees, a vicious treadmill cycle.

So as I said, the Fed has made a good step, but the rule, which doesn't go into effect until July 2010, that is too far from now. Too many families are struggling to make their minimum payment. And while the Fed's intentions are now good, we cannot be too shortsighted. There is going to come another time when credit will be loose and issuers will seek to roll back some of the important protections the Fed has implemented. That is why we must legislate.

I have introduced the bill on the Senate side along with my friend, Senator Udall, that Congresswoman Maloney, my colleague, has introduced and successfully passed on the House side. And I know that Senator Dodd is considering many of the points in that legislation, as many of my other colleagues' legislation, when he puts together a bill, and I hope we will move one quickly, Mr. Chairman.

Senator JOHNSON. Does anyone else feel absolutely compelled to make a comment?

Senator REED. Can I make a very, very, very brief comment?

Senator JOHNSON. Senator Reed.

STATEMENT OF SENATOR REED

Senator REED. I think what my colleagues have said is that despite the first step by the Federal Reserve, we have to be very, very sensitive to the capacity and willingness of the Federal Reserve to actually protect consumers when it comes to credit cards, and I think that issue has to be before our panel and I am glad the Chairman has brought the issue to us and to this panel of witnesses.

Thank you, Mr. Chairman.

Senator JOHNSON. Senator Tester?

STATEMENT OF SENATOR TESTER

Senator TESTER. I will be brief, Mr. Chairman.

In the good old days, you used to take a loan and you used to pay it back. Under the current scheme that goes on with credit card companies, you take out a loan and then they start attaching fees and increasing interest rates, and by the time you get done, you are paying it back, but none of it is going to the principal.

There are a lot of issues out here. My friend, Senator Brown, talked about how the college kids are being roped into this kind of thing. I just think it puts everybody in a bad boat. I think the Federal Reserve did take a first step, but it was only a first step. I look forward to working on this bill.

Senator JOHNSON. Anyone else? If not, I am pleased to welcome Mr. Adam Levitin to the Committee. Mr. Levitin is an Associate Professor at Georgetown University's Law Center specializing in bankruptcy and commercial law. Before joining the Georgetown faculty, Professor Levitin was in private practice at Weil, Gotshal and Manges, LLP, in New York and served as a law clerk at the United States Credit Appeals for the Third Circuit.

Our next witness will be Mr. Ken Clayton. Mr. Clayton has been with the American Bankers Association since 1990 and is currently the Senior Vice President and General Counsel of the ABA Card Policy Council, the group responsible for recommending policy within the ABA on all card-related issues. Mr. Clayton, we welcome you to the Committee.

Mr. Jim Sturdevant is founder and partner of the Sturdevant Law Firm in California and is an experienced litigator who has represented consumers in a number of significant consumer justice cases. In addition to his active litigation practice, Mr. Sturdevant is the Past President of the Consumer Attorneys of California and a member of the Board of Directors of the National Association of Consumer Advocates. We welcome you to the Committee.

We welcome Professor Todd Zywicki. Professor Zywicki teaches at the George Mason University School of Law in the area of bankruptcy and contracts. From 2003 to 2004, Professor Zywicki served as Director of the Office of Policy and Planning at the FTC.

Next will be Professor Lawrence Ausubel. Mr. Ausubel is a Professor of Economics at the University of Maryland and he has written extensively on the credit card market and other aspects of financial markets. Professor Ausubel, we welcome you to the Committee.

Last will be Mr. Travis Plunkett. Mr. Plunkett is the Legislative Director of the Consumer Federation of America, a nonprofit asso-

ciation of 300 organizations. He is a regular witness in this Committee and we welcome him back.

I welcome you all to the Committee and look forward to your testimony.

Mr. Levitin, why don't we proceed with you.

**STATEMENT OF ADAM J. LEVITIN, ASSOCIATE PROFESSOR OF
LAW, GEORGETOWN UNIVERSITY LAW CENTER**

Mr. LEVITIN. Good morning, Mr. Chairman, Ranking Member Shelby, and members of the Committee. I am pleased to testify today in support of the Chairman's Credit Card Accountability, Responsibility, and Disclosure Act and other legislation that would create a more efficient and fair credit card market and would encourage greater consumer responsibility in the use of credit.

Credit cards are an important financial product. They offer many benefits and conveniences to consumers. But credit cards are also much more complicated than any other consumer financial product, and unnecessarily so. Auto loans, student loans, closed-end bank loans, and all but the most exotic mortgages are relatively simple. They have one or two price terms that are fixed or vary according to an index. Not so with credit cards. Credit cards have annual fees, merchant fees, teaser interest rates, purchase interest rates, balance transfer interest rates, cash advance interest rates, overdraft advance interest rates, default or penalty interest rates, late fees, over-limit fees, balance transfer fees, cash advance fees, international transaction fees, telephone payment fees, and probably several other fees of which I am unaware.

In addition to these explicit price points, there are also numerous hidden fees in the form of credit card billing practices. The card industry has been ingenious in creating tricks and traps to squeeze extra revenue out of unsuspecting consumers. These billing tricks cost American families over \$12 billion a year.

Credit card billing tricks make cards appear to be much cheaper than they actually are, and that leads consumers to use cards too much and to use the wrong cards. By disguising the cost of using cards through billing practices, card issuers are able to maintain uncompetitively high interest rates and to generate greater use of cards. That produces additional revenue from interchange fees for the issuers as well as over-limit fees, late fees, and penalty fee revenue.

The complexity of credit card pricing makes it impossible for consumers to accurately gauge the price of any particular credit card, and unless consumers can gauge the cost of using a card, they cannot use it efficiently and responsibly. Markets cannot function without transparent pricing because demand is a function of price. The lack of transparency in credit card pricing has resulted in inefficient and irresponsible use of credit, and that has resulted in dangerously over-leveraged consumers, who are paying too much for what should be a commodity product with razor-thin profit margins rather than one with a return on assets that is several multiples of other banking activities.

Consumer over-leverage is a factor that should concern all of us, especially today. There is nearly a trillion dollars of credit card debt outstanding. The average carded household owed almost

\$11,000 in credit card debt last year. That is a drop in the bucket compared with household mortgage debt, but even the most exorbitant subprime mortgage rate is rarely over 10 percent annually, whereas the effective APR on many credit cards—the effective APR—can easily be five times as high. And the harm to families is palpable. A single repricing due to a billing trick can cost a family between an eighth and a quarter of its discretionary income.

These levels of credit card debt are not sustainable. Dollar for dollar, a consumer with credit card debt is more likely to file for bankruptcy than a consumer with any other type of debt. And to the extent that consumers are servicing high-interest-rate credit card debt, that is money they cannot use to purchase new goods and services from merchants. The money siphoned off by credit card billing practices does not create value. It cannot be spent in the real economy.

The card industry's arguments that Congress should not interfere with their finely calibrated risk-based pricing are malarkey. Only a very small component of credit card pricing reflects risk. Almost all credit card pricing is a function of the cost of funds, the cost of operations, and the ability-to-opportunity price, not the function of risk.

Moreover, to the extent that credit card prices reflect a risk premium, it is a pool-based premium. It is not an individualized risk premium. The card industry is not capable of pricing for risk on an individual basis. The technology is not there. This means that there is inevitably subsidization of riskier consumers by more creditworthy ones.

Nor is there any evidence that connects the so-called risk-based pricing to lower costs of credit for creditworthy consumers. While it is true that base interest rates have fallen, that is almost entirely a function of the lower cost of funds, and the decline in base interest rates has been offset by increases in other credit card prices. According to the GAO, for 1990 to 2005, late fees have risen an average of 160 percent, and over-limit fees have risen an average of 115 percent.

Since the 1990s, credit card pricing has been a game of three-card monte. Pricing has been shifted away from the up-front, attention grabbing price points, like annual fees and base interest rates, and shifted to back-end fees that consumers are likely to ignore or underestimate.

The card industry's risk-based pricing story simply doesn't hold up on the evidence and is not a reason to refrain from much-needed regulation of unfair and abusive credit card billing and pricing practices that have had a deleterious impact on the economy and society. Legislation like the Credit Card Accountability, Responsibility, and Disclosure Act is a crucial step in restoring transparency and fairness to the credit card market and to letting American consumers responsibly enjoy the benefits of credit cards. Thank you.

Senator JOHNSON. Thank you, Mr. Levitin.

The panel should know that we will limit your remarks to 5 minutes in order to have a proper question and answer period.

Mr. Clayton?

STATEMENT OF KENNETH J. CLAYTON, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, CARD POLICY COUNCIL, AMERICAN BANKERS ASSOCIATION

Mr. CLAYTON. Thank you, Senator, members of the Committee. My name is Kenneth J. Clayton, Senior Vice President and General Counsel of the ABA Card Policy Council. I appreciate the opportunity to testify today.

Credit cards are responsible for more than \$2.5 trillion in transactions a year and are accepted in more than 24 million locations worldwide. It is mind boggling to consider the systems needed to handle 10,000 card transactions every second around the world. It is an enormous, complicated, and expensive structure, all dedicated to delivering the efficient, safe, and easy payment vehicle we have all come to enjoy.

As the credit card market has evolved to provide greater benefits and broader access, it has become more complex. As a result, legitimate concerns have been raised about the adequacy of disclosures and other regulations. In response to these concerns, the Federal Reserve and two other regulators released comprehensive rules that fundamentally change the protections offered to cardholders. In many respects, these rules reflect the input from those on this Committee and others. They have heard you.

Federal Reserve Chairman Ben Bernanke noted that the new rules were, and I quote, "the most comprehensive and sweeping reforms ever adopted by the Board for credit card accounts." These changes have forced the complete reworking of the credit card industry's internal operations, pricing models, and funding mechanisms.

As this Committee considers new restrictions on credit cards, it is important to understand the sweeping nature of the Fed's rule and the extent to which it has already addressed the core concerns of cardholders. The rule essentially eliminates many controversial card practices. For example, it eliminates the repricing of existing balances, including the use of universal default. It eliminates changes to interest rates for new balances for the first year that the card is in existence. It eliminates double-cycle billing. It eliminates payment allocation methods perceived to disadvantage customers. And it eliminates high up-front fees on subprime cards that confuse consumers over the amount of credit actually available.

The rule likewise ensures that customers will have adequate time to pay their bills and adequate notice of any interest rate increase on future balances so they can act appropriately.

Perhaps most importantly, the rule provides significant enhancements to credit card billing statements, applications, solicitations, and disclosures that ensure that consumers will have the information they want in a manner they will understand and in a format they will notice so they can take informed actions in their best interests.

These new rules will have even broader implications for consumers, card issuers, and the general economy. The rules affect every aspect of the credit card business, from how cards are funded to how they are priced to how they are marketed and to how credit is allocated among customers with different credit histories and risk.

For example, because of the limitations on the repricing of risk, the rules will reduce credit availability and increase the price of credit. The rule will also impact the ability of card lenders to fund consumer loans in the secondary market as pricing restrictions coupled with increased delinquencies in this recession make investors very wary of buying asset-backed securities backed by card receivables. These securities fund about half of all card loans, to the tune of \$450 billion. This can have enormous implications for the U.S. economy going forward and it is why the Fed and Treasury are currently working hard to unlock this market.

Finally, the rules will impose enormous operational challenges for card issuers. Card lenders must completely overhaul internal processes, software, billing, product lines, advertising, customer service, and a host of other internal workings. Risk management models must be completely revised.

The Fed understood the enormity of this challenge and stressed that adequate time to implement it is critical to avoid significant harm to consumers, and I want to stress that last point about the harm to consumers because there is a real concern that moving the date up on some of these rules will actually end up harming the consumers more than it benefits them.

In closing, we would urge that any discussion over further legislation in this area be viewed in the context of the recent Federal Reserve rule, recognizing its sweeping nature, protection to consumers, impact on operations, and most importantly, its potential impact on our broader economy and the provision of credit to consumers and small businesses.

Thank you. I would be happy to answer any questions you have.
Chairman DODD.

[Presiding.] Thank you very much. I appreciate your testimony and your presence here.

Did you introduce all the witnesses?

Senator JOHNSON. Yes.

Chairman DODD. You did? Well, then Mr. Sturdevant, we welcome you, as well.

Mr. STURDEVANT. Thank you, Mr. Chairman.

Chairman DODD. I read your testimony last evening, as I read all of yours, and it is very, very helpful.

STATEMENT OF JAMES C. STURDEVANT, PRINCIPAL, THE STURDEVANT LAW FIRM

Mr. STURDEVANT. Thank you very much, Mr. Chairman. I am pleased to be here. I was here 2 years ago, in January of 2007, when you last convened a hearing on this subject. By way of background and simply to address the Federal Reserve's efforts in this regard, it began a quest in 2007, as well, with Solicitor comments. They finally came up with a set of rules late last year, but those rules won't take effect until 2010, which is why we need legislation this year and why I strongly support your legislation, Mr. Chairman.

By way of background—

Chairman DODD. Who is the next witness here?

[Laughter.]

Mr. STURDEVANT. By way of background and to put the fees that have been identified both in numbers and names and amounts into some perspective, I tried two cases, one in the late 1980s and one in the early 1990s, one against Wells Fargo Bank and another against First Interstate Bank, which now no longer exists, and the issues in the case were whether or not \$5 late fees and \$10 over-limit fees were excessive damage amounts for a simple breach of contract by the customer. We proved to a jury in the Wells Fargo case and to an experienced judge in the First Interstate case that \$5 exceeded the damages resulting from breach of contract for late payments and that \$10 was \$9 too much for someone who exceeded the authorized credit limit.

As the Committee knows, beginning in 1996 with the U.S. Supreme Court's decision in the Smiley case, which allowed credit card companies to export anything they could charge in the home State where the credit card company was based, they could export interest rates and then, according to the Comptroller of the Currency, interest rates included late payment fees, advance fees, over-limit fees, membership fees, quick-look fees, whatever, all of these penalty fees then went from \$10 or \$15 to the present average level of \$39. If they couldn't justify \$5 or \$10 in the late 1980s or early 1990s, they couldn't come close to justifying anything approximating \$39 today.

I was also co-lead counsel in a nationwide case against Providian Bank in the late 1990s and early years of this century. Providian's challenges were practiced from A to Z. Its entire credit card operation was abusive, predatory, and designed to lure low-income customers into situations where instead of a regular loan, they weren't paying off any of the principal. They were simply paying penalty fees, higher interest fees, balance transfer fees, *et cetera*. In order to stay in business, the Comptroller of the Currency required Providian to pay \$300 million. The company was sued in private litigation and also by the City and County of San Francisco.

And while Senator Schumer was here, he remarked on two of the then-shocking practices of Providian. One was to do a nationwide search to see where to locate its credit processing office, and they found that New Hampshire was the place where, on average, it took the longest amount of time for a letter to be mailed from any point in the country. But still, that wasn't enough to trigger enough late fee revenue at \$39 a payment. They then issued bar code payment envelopes that would never reach the payment processing center in New Hampshire and were investigated on three separate occasions by the United States Postal Service for that. One can only imagine what would have appeared at trial had we not settled the case several years ago.

And finally, two cases, *Badie v. Bank of America*, which I tried in the mid-1990s and won on appeal, and *Ting v. AT&T* challenged the attempts by Bank of America, on the one hand, and AT&T to impose mandatory pre-dispute arbitration clauses on their customers. In the Bank of America case, it was an attempt through a bill stuffer sent with statements which are multi-page documents and other marketing materials to alert its customers that it was replacing the civil justice system with a private system of arbitration.

And then in the Ting case, we challenged AT&T's attempt to impose not only mandatory arbitration, but several different unconscionable provisions, as well, unconscionable under California law because they prohibited class-wide adjudication, they imposed a secrecy gap on the consumer, they limited remedies otherwise available in litigation.

The latest abuse, revealed last week by Chase, was to send out a bill stuffer which required many of its customers to increase the minimum payment from the standard in the industry, which had been 2 percent of the balance, to 5 percent. For low-income people, an increase of 250 percent per month is more than significant and absolutely almost universally triggers default. For people at higher-income brackets, making a payment that usually was \$99 a month and then trying to pay \$250 a month is difficult in these financial times, as well.

Chase also thought it appropriate to impose a \$10 administrative fee because I think the industry had simply run out of names for the fees that it charges. I have included in my written testimony a list of the fees that Professor Levitin mentioned.

Mr. Chairman, I support your bill. I support provisions of the bill introduced a year ago by Senators Levin and McCaskill. I support Congressman Maloney's bill. Consumers in this country need legislation and they need a combination of enforcement by Federal officials, by State officials, and by private litigation, where necessary, to enforce the prohibitions that I hope this Congress will enact and President Obama will sign.

In closing, let me say this. Professor Elizabeth Warren from Harvard, who chairs the TARP Committee, has written a paper and advocated something akin to the Consumer Product Safety Commission for financial services, which I know you are aware of and hopefully other members. This will elevate for education purposes to consumers and to students, who Senators Brown and Tester talked about, the serious traps for the unwary that the credit card industry in its current form presents.

Thank you for inviting me to testify. I would be happy to answer any questions.

Chairman DODD. Well, I thank you very, very much. The complexity of it all for consumers is not accidental, in my view.

Mr. Zywicki, thank you.

**STATEMENT OF TODD J. ZYWICKI, PROFESSOR OF LAW,
MERCATUS CENTER SENIOR SCHOLAR, GEORGE MASON
UNIVERSITY SCHOOL OF LAW**

Mr. ZYWICKI. Mr. Chairman and members of the Committee, it is a pleasure to appear before you today. Let me make clear at the outset, I have no relationship with the credit card industry. I fight with them just like everybody else does. I disagree with them, just like any other company from which I buy goods and services, and you may find this hard to believe, but sometimes I even disagree with my elected representatives on various issues.

And I am really quite ruthless and not the slightest bit sentimental about leaving one card and switching to another if a better deal comes along. I don't care whether the industry makes a lot of money or a little bit of money. What I care about is maximizing

consumer choice and maximizing competition in a manner that will be consumer welfare-enhancing, and I fear there are many provisions in this legislation that may have unintended consequences that will lead to higher interest rates for consumers, will stifle market and regulatory innovation, and will restrict consumer access to credit at a particularly inopportune time.

Unlike almost any other good or service, credit card issuers are forced to compete for my loyalty every time I pull out my wallet to make a payment. I have got four credit cards. I decide at any given time which one is the best one for me to use, whether I am buying gasoline or shopping online. In such a competitive environment, credit card issuers face relentless competition to retain my loyalty, and as I said, I am not the slightest bit sentimental about switching if a better deal comes along.

Federal Reserve surveys indicate that 90 percent of credit card owners report that they are very or somewhat satisfied with their credit cards, versus 5 percent who are somewhat dissatisfied and only 1 percent, that is one out of 100, who say that they are very dissatisfied with their credit cards. Moreover, two-thirds of respondents in a Federal Reserve survey also reported that credit card companies usually provide enough information to enable them to use credit cards wisely, and 73 percent stated that the option to revolve balances on their credit cards made it easier to manage their finances, versus 10 percent who said this made it more difficult. So let us not throw out the baby with the bath water.

Nonetheless, the myriad uses of credit cards and the increasing heterogeneity of credit card owners has spawned increasingly complexity in credit card terms and concerns about confusion that may reduce consumer welfare. Nonetheless, we should not sacrifice just for the sake of making credit card simpler some of the benefits that we have generated from credit cards. Consider some of the more troubling provisions in the legislation to my mind.

First, there are some provisions that will likely lead to higher interest rates and other costs for consumers. For instance, and many of these are in the Federal Reserve rules but I still am troubled by them, and to the extent that they are phased in rather than posed immediately, I believe that will be better for consumers. First, for instance, it prohibits the application of any rate increases on an outstanding balance on credit cards, often called retroactive rate increases. The way credit cards operate is they are revolving credit. They are month-to-month loans. That means at any given time, I can cancel my card and go to a lower interest rate card. To the extent that issuers are unable to raise the interest rate when situations change but I am allowed to switch to a lower interest rate when situations change, the end result of that is that issuers are going to be less likely to offer lower interest rates on the front end. If I can lower my interest rate but it can't be raised if circumstances change, they are going to be less likely to offer lower rate interest cards.

Second, the provision that has to do with application on outstanding balances suffers from the same sort of problem.

Second, I am concerned that some of the things in this legislation will stifle innovation. For instance, the provision that requires an ongoing payoff, a timing disclosure that includes, for instance, a

statement to the consumers how long it would take to pay off the card balance by only making the minimum payment. This would go on every billing statement. According to research by Federal Reserve economist Thomas Durkin, this provision would be of interest to approximately 4 percent of credit card users, being those who intend to pay off their balance by making the minimum payment and intend to stop using the card.

It is an open question whether or not it is worth mandating a brand new disclosure for 4 percent of consumers, much less one that would be conspicuously disclosed. Why is that a problem? Because the more things that you require to be disclosed and the bigger you require it to be disclosed, the more distracting and more difficult it becomes for consumers to find out what they actually want.

More fundamentally, I think this illustrates a one-size-fits-all strategy to consumer protection that is not accurate in the context of credit cards. The reason why credit cards are so complicated today is because consumer use of credit cards is so multi-faceted. Consumer cards offer an endless array of terms that respond to the endless array of demands of different consumers. Some consumers never revolve. Some consumers revolve sometimes. Some consumers revolve all the time. I never revolve. I have no idea what my credit card interest rate is. I don't care. I don't shop for a card on those terms. I care about what my annual fee is and what my benefits are.

To the extent that we mandate certain disclosures, it makes it more difficult for consumers to shop on the terms that they actually want, and the empirical evidence on this is clear. Consumers do shop on the terms that they want. Those who revolve, unlike me, do know what their interest rate is, by and large, and they shop very aggressively on that. The best evidence we have is that those who revolve balances actually have a lower interest rate on their credit card than those like me who don't pay interest and so don't shop on that particular term.

To the extent, then, that we also place limits on penalty fees and that sort of thing, we are going to reduce risk-based pricing by requiring interest rate raises for everybody else.

The final thing I would like to close on is the concern that this might reduce credit access. We know what has happened during this past year as credit card access has dried up and credit limits have declined. Reports indicate that middle-class—some people have been forced to go without things they wanted. Other reports indicate that those who are unable to get credit cards have been, for instance, forced to turn to layaway plans. They brought back layaway this fall because people couldn't get credit cards. Other people have had to turn to payday lenders. Other middle-class people have turned to pawn shops.

To the extent that the impact of this law is to reduce access to credit, it will harm those who we intend to help, and in particular, I would urge caution, although it is obvious college students often misuse credit cards, I would urge caution at this particular time at doing things that might limit access to credit for college students. We know that the student loan markets are not performing very well right now either, and we know that a lot of college students

drop out when they can't get access to credit. So it may be that on net, some of those are appropriate, so let us not be overzealous in a way that might lead to reduced access to credit.

Thank you.

Chairman DODD. Thank you very much.

Dr. Ausubel.

**STATEMENT OF LAWRENCE M. AUSUBEL, PROFESSOR OF
ECONOMICS, UNIVERSITY OF MARYLAND**

Mr. AUSUBEL. Good morning, Chairman Dodd, Ranking Member Shelby, and members of the Committee, and thank you for inviting me here. My name is Lawrence Ausubel. I am a professor of economics at the University of Maryland and the author of perhaps the most cited article on credit cards in the scholarly literature.

Penalty interest rates or risk-based pricing, this is the question of the day. Consumer advocates assert that when the typical issuer raises the credit card interest rate by 12 to 15 percent following a late payment, this is penalty pricing intended to take revenues from their most vulnerable customers. However, industry representatives respond that consumers who miss payments are the most likely to eventually default and all they are doing is requiring the riskiest consumers to shoulder their true cost.

My testimony will seek to address which characterization is more accurate. The consumer view would justify legislation, such as the Dodd bill, while the industry view would suggest that such rules are misplaced.

Unfortunately, the data necessary to answer this question are typically confidential and out of reach. However, in 2008, Morrison and Foerster issued a data study on behalf of lenders which tracks various delinquency events such as going 16 to 30 days past due or going three or more days past due on two separate occasions, and it reports the percentage of consumers who ultimately default. Using their reported numbers, one can perform simple back-of-the-envelope calculations that answer the question of the day.

The data enable me to reach the conclusion that the increases in interest rates bear no reasonable relation to default risk, *i.e.*, these are penalty interest rates that demand regulation. Here is a simple calculation. Accounts that were 16 to 30 days past due in May 2006 experienced higher defaults than accounts that were current. Twenty-point-seven percent of these balances went into default, as defined by the study, over the following 22 months as compared to 9.3 percent for accounts that were current.

Converting these percentages into annual rates of net credit losses gives an increased economic loss per year of 4.5 percent. However, the standard repricing in the marketplace is a 12 percent to 15 percent increase. Let me repeat that. Economic loss of 4.5 percent versus standard repricing of 12 to 15 percent. This is three times greater. By any standard, this is penalty pricing, not risk-based pricing.

Moreover, this calculation is overly generous to the industry in several respects. For example, the data study omits late fees, typically \$39, which are imposed above and beyond the interest rate increases. Further, to be more than fair, I selected 16 to 30 days late as my selection criterion. Using a trigger of just two to 5 days late,

as some banks do, one can get the economic loss down below 2.5 percent per year. And again, the standard increase is 12 to 15 percent.

At the end of the day, the economic conclusion is inescapable that these are penalties based not on cost, but on demand factors, and observe that the demand of consumers facing penalty rates is rather inelastic. They are often borrowed up, distressed, and have diminished alternative borrowing opportunities.

I should also emphasize that a retroactive penalty rate increase for distressed consumers is precisely the opposite policy prescription that we apply in other areas of lending. For example, there is a growing consensus today that in the mortgage area, loan modification, *i.e.*, reductions as opposed to penalties, are needed.

To summarize, economic analysis of recent data supports stricter regulation of the credit card industry, particularly with respect to penalty interest rates imposed on existing balances. The Fed has taken some action in this area, but regrettably, the regulations are weak and the effective date is not until July 1, 2010. The current economic crisis makes it all the more urgent that Congress adopt the Dodd bill sooner.

So to close, Chairman Dodd, I support the bill you introduced yesterday.

Chairman DODD. Thank you very much, Doctor. I appreciate that very much.

Travis Plunkett has been before the Committee on numerous occasions with the Consumer Federation of America. We thank you for being here.

STATEMENT OF TRAVIS B. PLUNKETT, LEGISLATIVE DIRECTOR, CONSUMER FEDERATION OF AMERICA

Mr. PLUNKETT. Thank you, Chairman Dodd, members of the Committee. I am Travis Plunkett, the Legislative Director at the Consumer Federation of America. I am testifying today on behalf of CFA and five other national consumer organizations. I appreciate the opportunity to offer our analysis of the very serious national consequences that unfair and deceptive credit card practices are having on many families in this recession as well as what this Committee can do to stop these traps and tricks. American families cannot become the engine of economic recovery if they are burdened by high credit card debt that can further escalate at a creditor's whim.

I would like to summarize five points that I will leave with the Committee and then come back at the end of my testimony and provide a little detail on each point.

First, the number of families in trouble with their credit card loans is approaching historic highs, as Senator Dodd said. Based on loss trends the card issuers are reporting, 2009 could be one of the worst years on record for credit card consumers.

Second point, credit card issuers share a great deal of responsibility for putting so many Americans in such a vulnerable financial position through their reckless extension of credit over a number of years and use of abusive and unjustified pricing practices, which seem to be accelerating at this time when consumers can least afford it.

Third, the need for quick action to end abusive lending practices is more urgent than ever now because taxpayers are propping up major credit card issuers through several enormously expensive programs. If the government is going to attempt to spur credit card issuers to offer more credit, it must ensure that the loans they are offering now are fair and sustainable.

Fourth, the recent credit card rule finalized by the Federal regulators is a good first step in curbing abusive practices. It does have significant gaps, though, and as we have heard, it doesn't take effect until July of 2010.

Fifth, Senator Dodd's comprehensive Credit Card Act fills in many of these gaps, as do a number of other legislative proposals that have been offered by members of this Committee. It will make the credit card marketplace fairer, more competitive, and more transparent.

So let us talk a little detail here. On loss trends, Senator Dodd went through some of the most worrisome factors. One thing to watch is something industry insiders look at a lot. It is called the payoff rate. This is the amount of money that credit card consumers pay on their credit card bill every month and it has just dropped at the end of last year precipitously for credit cards. It is now at one of the lowest levels ever reported, showing that cardholders are having a harder time affording their bills and that the amount of money they can pay every month is dropping.

Charge-offs and delinquencies—charge-offs is the amount of money proportionate to how much is loaned that credit card issuers write off as uncollectible—it is looking like they may approach the highest levels ever by the end of this year, and they are already quite high and have shot up very fast. Personal bankruptcy is up by about a third.

On the responsibility that issuers have for this problem, just so you don't think this is last year's news or old news, let me just cite a few recent problems with some of the pricing practices you have heard about. They involve issuers adding new fees, increasing the amount of fees that they are charging, using harmful rather than responsible methods to lower credit lines, and a number of other abusive practices.

Citigroup last fall back-pedaled on its promise to not increase interest rates any-time for any-reason, and then increased interest rates on a large part of their portfolio. Chase, as we have heard, has suddenly started charging people \$120 a year for their accounts. These are cardholders who were promised a fixed rate for the life of their balance. Bank of America has used a variety of questionable methods for cardholders who appear to have done nothing wrong to violate their agreement, citing risk-based pricing and not providing clear information to these cardholders about the problem. Capital One and a number of other issuers over the last year, year and a half, have used very vague clauses in the cardholder agreements that allow them to increase interest rates for large parts of their portfolio for so-called market conditions.

Let me be clear. Issuers do have the right to try and limit their losses in a recession, but these kinds of arbitrary and unjustified practices for cardholders who thought they were playing by the rules are very, very harmful.

On the need for quick action because of government support, a couple of days ago, Treasury Secretary Geithner announced the expansion of a program that is supposed to provide taxpayer dollars to support securitization of credit card loans. They want more credit card lending. We have urged the Secretary to establish minimum fair practices standards for credit cards now so that our tax money isn't supporting unfair loans.

On the Federal Reserve and regulator credit card rule, several positive aspects that we have heard about to the rule related to double-cycle billing, restrictions on increasing interest rates on existing balances, payment allocation. There are gaps, though. Fees are not addressed at all. Credit extension is not addressed at all. Bringing down rates if cardholders say they have a problem, then they pay on time for, say, 6 months, not addressed. And as we have heard, it doesn't take effect for a long time.

The Credit Card Act and a number of other bills introduced in the Senate address many of these gaps. No any-time, any-reason repricing. That is the excuse Chase used. Limiting unjustified penalty fees by requiring that fees be reasonably related to the cost issuers incur, a very important part of the Credit Card Act. Limiting aggressive marketing and irresponsible lending to young consumers and lowering rates if consumers perform well after a problem occurs.

Let me just close by saying that we have heard a lot about fears that fair regulation of the credit card market will lead to less credit, will lead to people who need it not having access to credit, especially lower-income or minority consumers. I always get a little worried because this context, or the context for this discussion is to ignore what has happened through essentially self-regulation of the market. I mean, where are we now? Issuers have been able to write their own rules for a very long time and they are cutting back on credit, especially to more vulnerable borrowers, especially to lower-income and minority borrowers. Plus, we have to deal with the kind of uncompetitive, not transparent marketplace we have heard about.

So it sounds like the worst of all possible worlds to me, and that is why we support Senator Dodd's bill and fair regulation of the marketplace.

Chairman DODD. Thank you very much, and I appreciate your comments, and all of you here this morning for your counsel on this issue, which is, again, a complex one and one that deserves our attention.

I want to also make two points. One is credit cards are a tremendously valuable and worthwhile tool for consumers. I think it is very important. This is not a Committee, or at least an individual here that is hostile to the notion of credit cards at all. Quite the contrary.

Second, I respect immensely that Ben Bernanke and the Federal Reserve moved on the issue of regulation, and while there are gaps and problems I have with what they have done, he is the first Chairman of the Fed that has actually moved in this area, despite the issue having been raised for a long time, and I certainly want to reflect my appreciation for the steps they have taken. I am dis-

appointed that you have got to wait until July of 2010 for them to become effective, but nonetheless I want the record to reflect it.

I was very impressed, Mr. Levitin, with this study and I highly recommend to my colleagues. It is lengthy in some ways. It is a number of pages long, some 20 pages long, this analysis of the credit card industry and how it works. But one thing that struck me at the outset of the report is something I think we kind of blow through, and that is the credit instruments that we use as Americans are tremendously valuable—the home mortgage, the car loan, the student loan. And the point that you make, or that this report makes is, of course, the pricing points, and I think it is a very worthwhile point to make.

In almost every one of these other transactions, pricing points are rather clear. They are one or two or three, maybe four, but you have a pretty clear idea. You know with almost certainty what your mortgage is going to be, what your car payments are going to be, what your other payments are regardless if you take credit.

When you get into this area, it is exactly the opposite, and I was stunned at the pricing points and why, in terms of taking on this responsibility, knowing what your responsibilities are going to be, you are faced with the following, just on pricing points, an astounding array of points—annual fees, merchant fees, teaser interest rates, base interest rates, balance transfer interest rates, cash advance interest rates, overdraft interest rates, default interest rates, late fees, over-limit fees, balance transfer fees, cash advance fees, international transaction fees, telephone payment fees. These are all the pricing points in credit card negotiations.

To expect a consumer to appreciate and absorb that many pricing points when you are trying to determine whether or not taking on that financial responsibility—now, again, we are not going to eliminate all of these, but the idea that a consumer is able to juggle and understand that many different pricing points when you are making a determination as to whether or not you ought to engage in a service or a product purchase.

I was stunned, as well, on the issues of bankruptcy and the like in terms of driving these costs up and the complexity of dealing with it.

Again, I draw my colleagues' attention to this report. I think it is extremely useful. It gets into the issue of the risk-based pricing issue, as well, that Dr. Ausubel referenced, but I think it is an important point, as well.

It is an industry that started out making its money on interest rates, and that was where the money was made. It has transferred itself from interest rates to fees, and that is the \$12 billion increase in fees that have occurred that have added so much cost and confusion.

Mr. Clayton, thank you for being here. One of the issues that is obviously of concern to many of us is the universal default. I think most people understand it, but the idea that if you are current on your credit card responsibilities, but if you are late on an electrical bill or a phone bill or the like, that we have seen examples where the issuers will then raise fees or rates as a result of your late payments on unrelated responsibilities, financial responsibilities.

Now, it is true that, in a sense, the new rule to some degree eliminates the universal default. But under the rule, as well, and having conversations with the Fed about this, issuers can still look to off-comp behavior to increase interest rates. And so while it talks about banning it on one hand, it still tolerates the issue of actually accounting for off-balance behavior to increase rates that consumers pay. I would still call that universal default. If, in fact, the issuer can raise rates by considering these late payments in unrelated matters to the credit card, then it still seems to me that universal default exists. How do you respond to that?

Mr. CLAYTON. Well, Senator, I know there has always been this discussion about how universal default is defined and I understand respect the fact that people take different perspectives. But it is our understanding that the Fed permits the changing of interest rates on existing balances under four conditions and four conditions alone.

The first condition is if it is a promotional rate card, essentially, and it is disclosed ahead of time and that promotional rate expires.

The second one is if it is a variable rate card tied to some kind of index.

The third one is if there is a delinquency in excess of 30 days.

And the fourth one is if it is a violation of a work-out agreement.

I am unaware of any other circumstance where, when this rule becomes effective, that institutions can consider off-account information in determining the interest rate on that existing balance.

Chairman DODD. Mr. Sturdevant, do you have any comment on this, or any of you who are familiar with it?

Mr. STURDEVANT. I am concerned about the Federal Reserve's rule, particularly in light of your comments, not simply today, but 2 years ago about this very issue, and in terms of consumer expectations under agreements that now exceed 30 pages in length about what they are getting when they get a credit card. I mean, I think Senator Tester is right, and you were right, Mr. Chairman, on auto loans. You know what you are getting. You know what you are paying. In the old days of banking, they loaned the money out and they took deposits in. We don't do that anymore.

And the problem with universal default is consumers do not understand that if they have a problem with a utility bill or some other relationship, that the interest rate is going to skyrocket, that the penalty fees are going to be imposed. That is what universal default does. It is a complete trap for the unwary and it needs to be prohibited, not regulated.

Mr. PLUNKETT. Senator, to answer your question, universal default would be allowed prospectively. The Federal Reserve rule deals with increases on existing balances.

Chairman DODD. But not going forward?

Mr. PLUNKETT. But not going forward. So they could decide that they didn't like my library fines or my utility payment and increase my—you know, send me a notice saying that going forward, as long as they met other requirements of the law—

Chairman DODD. Despite the fact that you are absolutely current. What I am suggesting, if you are late and various things, under reasonable rules, having fees and penalties and so forth. We are not talking about that. We are assuming that that consumer

is absolutely current in their payments on their credit card responsibility, and then still because they are late on some other charges, that then justifies increasing the rates on that consumer going forward.

Mr. PLUNKETT. Our reading of the rule is that that would be allowed going forward.

Chairman DODD. Can you imagine the effect it would have if you were late on your credit card and the phone company or the electrical company decided, we are going to increase your rates because you didn't pay your credit card on time? What would be the reaction? Do you have a comment?

Mr. CLAYTON. Senator, can I jump in for a second? First of all, card companies don't consider whether you are late on a telephone bill or utility bill as part of what is in their credit records.

The other thing is that consumers have absolute control here. This is about future balances. And I would note, by the way, that the Fed said that you cannot increase future balances for the first year of the card. That is the first thing. Plus they gave you notice of that effect. And it gives you the choice of walking. If you don't like what the card company is doing, there is a lot of competition out there and choice for people, and that is the ultimate controlling mechanism here. Consumers can just say no. And it is not that hard and we need—

Chairman DODD. Why do you have to—why all these fees and rates and so forth? Is that really the answer to consumers? If you don't like this, what we are loading you up with and charging these fees, just take a walk?

Mr. CLAYTON. Well, but that is what you do every time when you walk by and decide whether you are going to buy a sweater in a store or not. But the other thing that is important to note that gets lost in this, credit cards, while they are loans, are fundamentally different. They are not secured. They are completely used with incredible flexibility for consumers at any time. You can use it 24/7 virtually anywhere in the globe. There is a huge amount of risk in making those loans available.

What we worry about, and we understand are sympathetic to the concerns being raised, the Fed has acted and we will obviously enforce that with all the strength we can. But the point is—

Chairman DODD. So the comments are coming then in favor of the Fed rules?

Mr. CLAYTON. We didn't necessarily agree with everything the Fed said, but it is the rule of law today and it is what we will have to comply with going forward and we will do our best to—

Chairman DODD. Are you in favor of them?

Mr. CLAYTON. There are concerns that people have raised about the impact it will have on availability of credit.

Chairman DODD. My time is up. Let me turn to Senator Corker. I have extended my time.

Senator CORKER. Mr. Chairman, thank you for having the hearing. I am going to be very brief. I have got something starting in about 3 minutes.

But let me just, Mr. Clayton, I just recently met with a number of folks that are in the credit card business and I got the sense that it wasn't a particularly rosy time. Could you give us a sense as to

how the industry itself right now is performing from the standpoint of making profits, losing money, just generally the state of the credit card issuers' business today?

Mr. CLAYTON. Sure. Credit card issuers are subject to the same economic influences that are out there affecting everyday consumers and every other lender in the country. Card companies are under particular stress right now. A number of them are losing money and have indicated in recent reports significant losses on their card portfolios, which actually reflects the underlying risk of this product. I mean, people talk about how much consumers are getting in debt or can't pay it back. Well, lenders who make loans to those people are the ones at risk here of not getting paid. So there is a significant amount of stress right now.

Senator CORKER. Mr. Chairman, I have got two daughters that are in college and every time we have a hearing or some discussion about credit cards, I literally call them that day—the credit card industry won't like this—to make sure they do not have a credit card, OK, that they have only a debit card or a check card. So I actually appreciate many of the fears that people and many of the concerns that people have laid out today regarding the credit card companies.

I have to tell you, I feel like I am semi-sophisticated—semi—and I get incredibly confused by all these things I get in the mail, and candidly, throw most of them in the trash. I just don't understand. So the marketing practices, I think, are things that need to be looked at.

So the only thing I would say is that we have this rule of unintended consequences that continues to sort of haunt us with actions that we take. While I think that certainly there have been abuses in fairness, at the same time, I think we have to be very careful. It seems that when we do things like this, in many cases, it is the lowest-income people that end up getting hurt the worst by our good efforts by virtue of having a lack of availability of credit. So I hope as we move through this, we will do this in a balanced way that does take into account some of the concerns that have been raised and I think are very fair. But at the same time, we understand that at the end of the day, these businesses are going to do those things in their self-interest, and when they do that, it may, in fact, end up harming the very people that this legislation is intended to help.

So thank you very much for this great hearing.

Chairman DODD. I appreciate that very much, Senator. We always appreciate that point. It is a worthwhile one. This is an ongoing issue.

I just say regarding young people and unsolicited mail, I have a 3-year-old that got a credit card the other day and they wanted to thank her for her wonderful performance as a consumer. She is a delightful consumer, I want you to know that, but the idea that she warrants a credit card at the age of three is troubling, needless to say. And the idea of having some ability to demonstrate you can pay or some cosponsorship, I think these are basic things that one would require. Let me stop there.

Senator Johnson?

Senator JOHNSON. Mr. Plunkett, the new Fed rules prohibit banks from increasing interest rates on credit card debt that a consumer has already accrued, increase the amount of time consumers have to make payments, change how a consumer's balance is computed each billing cycle, ensure that consumer payments go first to balances with the highest interest rates, and crack down on credit cards with low credit limits and APs. What other areas would you like to see improvements regarding consumer protections for credit cards?

Mr. PLUNKETT. Thank you for the question, Senator. A couple more areas we would like to see improvements. First, as we heard, fees have been growing faster than the cost of living. In many cases, penalty fees in particular seem to bear no relationship to the costs incurred by issuers if somebody pays late or goes over limit. So we like Senator Dodd's provision that fees should be reasonably related to the costs incurred by issuers.

We like the provisions in that bill and others related to lending to young people. Two things there. Senator Dodd talked about extending credit responsibly to young people or having a cosigner with income who can pay for the loan and not offering the loan to young people without much income.

The second issue in the bill, give young people a choice of whether they want to accept—a real choice—whether they want to accept credit card solicitations. So the bill has an opt in. You don't get solicited between 18 and 21 unless you affirmatively choose to allow it.

A third issue is bringing down rates after somebody makes a mistake. In many cases, issuers appear to be reserving the right to charge those rates for a long time, you know, many, many, many months. What the Dodd bill says is after 6 months, if you have been on time, if you haven't violated your agreement, rates have to come back down again.

Senator JOHNSON. I believe the time is incorrect.

Chairman DODD. Just keep going.

Senator JOHNSON. Mr. Clayton, I understand that the Fed's rules are not effective until July 2010. We have heard from some that this is too long and that legislation needs to be passed now to shorten this to a few months. Why do you think the Fed gives the industry so much time to put the rules in place?

Mr. CLAYTON. Thank you, Senator. One of the things that the staff and the regulators were careful to articulate when they issued this rule was the immensity of what was involved in changing what they are requiring. There are significant operational changes in terms of everything under the sun, in terms of how banks actually send out billing statements, how they coordinate, how they do anything that you see in paper has to be obviously tested, because there are significant compliance concerns that go with this and significant penalties for failure to get it right.

They also have to significantly rewrite how they price for risk because the rule places significant limitations on that. And as a practical matter, that takes time to figure out what is acceptable to consumers as well as what is acceptable to regulators and others.

The third point, and this is something I wanted to stress, is the funding aspect of this. As others have noted and I have tried to

note in my testimony, the credit card industry and consumers are essentially dependent on funding from investors. Half of the credit card funding that is provided for credit card loans comes out of the asset-backed securities market. It is why, in fact, the Treasury Department and the Federal Reserve are trying to come up with a way to unlock that market because it is currently locked right now.

The problem is, those securities were issued with the expectation by investors that there could be a risk-based repricing in the process, and so it has built into the models of those securities that people will actually pay back at certain rates and that the institutions have the right to change those rates in order to compensate for higher risk in the marketplace.

If you move this date up, in addition to all the operational headaches you run, you are going to end up changing the nature of that calculation and reducing the ability of credit card companies to meet the requirements of those securities. As a result, investors start running. They get nervous. They won't purchase it going forward, which actually operates in direct conflict with what the Treasury and the Fed are trying to do in unlocking this market, and it runs the risk in the worst case scenario, and we are not saying this happens, that some of these trusts have to be devolved. What that means is the hundreds of billions of dollars of repurchases back off from these receivables and you have to hold tens of billions of dollars in capital against that. That will significantly contract the availability of credit in the marketplace.

Senator JOHNSON. Mr. Ausubel, in recent months, we have seen lenders cut back the amount of new credit that they offer and reduce credit card lines. How has this impacted consumers?

Mr. AUSUBEL. Clearly, the financial crisis has led to the reduction in credit lines and this has been adverse to consumers. However, there is no evidence that credit card regulation or the Dodd bill would cause any further contraction in the availability of credit or increase the cost of credit. This has all been presented as industry rhetoric with no hard evidence.

The other thing just to add is people are using things—this is always done—people are using random recent events, like the cut-back in the securitization market—I should say the freezing of the securitization market to raise red flags here. The reason for the securitization market's freeze is the financial crisis and it is not a matter of concern whether banks can impose penalty rates on consumers.

Senator JOHNSON. Thank you. I yield back.

Chairman DODD. Thank you very much.

Senator REED?

Senator REED. Thank you, Mr. Chairman.

Following on Senator Johnson's question about this 18-month interval, just to be clear, Mr. Clayton, is there anything in the rules that would prevent credit card issuers from raising interest rates and increasing fees in that 18-month period?

Mr. CLAYTON. No.

Senator REED. Would there be an incentive to do so if these fees can be maintained after 18 months?

Mr. CLAYTON. Not necessarily, because ultimately the card companies have to answer to the marketplace, and if they raise rates,

there is always the opportunity for consumers to take it to another company. So it is not— credit card companies are not in the business of hurting their customers. Ultimately, they want them for the long term and long-term profit. So they are not looking to drive people away. If there are choices in the marketplace to provide a better deal, they know the consumers will take it.

Senator REED. Professor Levitin, what is the spread between the rates here? What is this price competition that Mr. Clayton has referred to that goes on so vigorously?

Mr. LEVITIN. Well, here is the problem with Mr. Clayton's story. It is that he is saying you can just say no. If a consumer doesn't like a prospective rate increase, the consumer can walk away. But that is not costless. There is a lot of lock-in with credit cards. If you want to walk away from a card because you don't like what the issuer is doing, it is not that simple. You have to go and find a new card. That takes some time. There are some transaction costs there, not high, but there are some, and you take a hit to your credit report. If you have a line of credit that was functioning just fine and you close it, that hurts your credit score.

Walking away is not costless, and I believe Professor Ausubel has a study on this and I should defer to him for a characterization of it, but if I recall, I think he estimated the costs of switching a card being around \$150 in total costs to a consumer.

Senator REED. Before I go to the Professor, just a response to my initial question. There is no disincentive to raising rates, and another particular question, there are certain categories of fees or charges that are prohibited after the 18-month period. If those fees or charges exist on that date for card customers, will they stay in effect or would they have to be conformed?

Mr. LEVITIN. Regarding your second question, I am not sure. Regarding the first question, there really is no disincentive for raising the cost because if you have a consumer who is locked in, if you raise their rates some—I mean, consider this. Right now, consumers can already walk away, but yet we see Citibank going and raising interest rates. On one of my Citi credit cards, Citi raised the rate. It went up—it was a 70-percent increase, seven-zero percent. Citi had to be calculating that I wasn't going to walk away.

Now, that card is way above the rate that I have from other cards, but the idea that Citi wouldn't do this, I mean, if Citi is smart and if banks are self-interested, as Mr. Clayton says, they wouldn't do this unless they know that I am not going to walk away, that they know that there is a serious lock-in effect. And that is why I don't think we are going to see that going forward the Fed rules are going to help us much.

Senator REED. Well, let me——

Mr. PLUNKETT. Senator, on your second question——

Senator REED. Mr. Plunkett, please.

Mr. PLUNKETT. I think the understanding is that the rule is prospective. So the baseline will be what issuers are doing at the time the rule takes effect in 17 months and it will not be retroactive in any way. It will affect behavior from that point on.

Senator REED. Let me ask another question. So a new customer comes online. They would still be subjected to the same policies and

practices, just essentially grandfathered, even though they have come online after 2010?

Mr. PLUNKETT. Well, going—on July 1, 2010, no matter when the customer comes on, they will be prohibited from certain things, like raising interest rates on existing balances if somebody is—unless somebody is more than 30 days late.

Senator REED. OK. But that existing interest rate is the baseline starting in 2010?

Mr. PLUNKETT. Yes, sir.

Senator REED. Professor Ausubel, Professor Levitin referred to your study. Could you comment?

Mr. AUSUBEL. Sure. One thing just to say on that last point is I do have serious concerns that issuers might exercise their prerogative under their any-time, any-reason clauses on June 30, 2010, to raise interest rates on existing balances.

As far as what Professor Levitin referred to, it is well established in the economics literature that consumers are subject to what are variously called search costs and switch costs. Search cost means the expense in time, resources of finding a better deal. Switch cost simply means the expense in time and resource of switching over, say, to a new card issuer. If you actually look at consumer-level data, consumers behave as if these search costs and switch costs are quite large.

Part of it is that it does take a while to restructure your financial affairs and move to a cheaper lender. Another thing that comes up is simply consumers behave as if they are, you might say, overly optimistic. So they have a \$3,000 balance right now, but sure, I am going to pay it off in a few months so the interest rate differential doesn't matter that much and I don't put as much effort into it.

Senator REED. Let me, if I may, a final question. If there is data out there, Professor, there is a search cost, but if the interest rate is not significantly lower, people make a rough calculation that those search costs are too expensive, what is the differential rate between Card A, Card B, and Card C? Again, I ask this because I don't know. It just strikes me as that most of these cards sort of parallel consciousness seem to have similar rate structures, similar terms, and maybe there is some differential, and I ask this because I don't know the answer, not to be rhetorical.

Mr. AUSUBEL. I would say in terms of the basic deal, there is a lot of similarity. I think what they are referring to is, say, take a consumer who has triggered a penalty rate. So it may be that they have access to credit card offers which end up having ongoing rates of 10 percent, 12 percent, and it might be because they were 5 days late on a repayment. Their existing issuer is charging them 26 percent. So that is where you are going to find the largest differentials.

Senator REED. But if they switch, the information of their default goes with them, or will it catch up with them?

Mr. AUSUBEL. Yes and no, and it looks like Travis might add to what I say. If it is triggered by less than 30 days past due, I believe that standard practice is that that is not reported to credit bureaus so it might not be obvious. On the other hand, if it is triggered by certain other things, including universal default, they had to learn

about it some way, other issuers would learn about it the same way.

Senator REED. Mr. Plunkett?

Mr. PLUNKETT. That is correct, Senator, and the obvious point here is if there is a record on a credit report, for example, somebody is more than 30 days late or there is another issue with their credit report that would allow the issuer to use universal default to reprice them, they are not going to switch in this climate. They are not going to be able to switch. It is going to be much harder. Issuers are being much more cautious and their ability to change cards will be very limited.

Senator REED. Thank you very much. Thank you, Mr. Chairman. I apologize for going over.

Chairman DODD. Not at all.

Senator Bennet, Michael?

Senator BENNET. Thank you, Mr. Chairman.

I just have a couple questions about interchange fees, and maybe for Mr. Plunkett and Mr. Clayton. The first question is, is there a way that I, as a card user, know what interchange fee is being charged by my credit card company or imposed on the merchants from whom I am buying products?

Mr. LEVITIN. It is impossible to know that as a consumer. The interchange fee schedules are incredibly complex. You would have to know what category your card falls in out of several categories. You would have to know what category a merchant falls in under several categories. So is the merchant considered a grocery store or is it considered a warehouse club, or is it considered a gas station or a restaurant? Some of these are fairly simple to figure out, some are not. Then you would have to know within those how much business the merchant does. So grocery stores that do over some hundred million dollars of business have a different rate than those that do less. And then you don't know what kind of—for a few very large merchants like Wal-Mart, they are able to get a sweetheart deal by basically being put in a special interchange category. There is really no way of knowing what costs you are imposing on the merchant.

What is important to note, though, is interchange means that it is not free to use a credit card. If you are a pure transactor like Professor Zywicki, there is still a cost for using the credit card. There is no free lunch here. You go to a merchant and you make a purchase with the card, and let us say the interchange rate is 2 percent on that card. That is 2 percent for what we should assume is really about a 15-day extension of credit. You make most—maybe your purchases on average are made in the middle of the month, so you have the extension of credit to the end of the month. On 2 percent for a 15-day extension of credit as an APR, it puts you at something around 52 percent APR.

There is a real cost for just using a card to transact, even if you aren't borrowing, and that is not a cost that is apparent to consumers because it is passed on to merchants in what is called the merchant discount fee and merchants are not allowed by credit card network rules to pass that on to card consumers. So people who are using credit cards, and especially people who are using fancy, high-cost credit cards are being subsidized by other con-

sumers. They are being subsidized by people who use cash, by people who pay with checks, by people who pay with Food Stamps, and that is a really inequitable subsidization.

Senator BENNET. I want to come back to that in a second, and I want to give Mr. Clayton a chance to respond, but is there a way, and anybody can answer this, but given how opaque that is and untransparent that is, are there things we could do to address that issue so that consumers and merchants have the information?

Mr. ZYWICKI. Well, it is a more—Senator, it is a more general issue. There are costs to every payment mechanism. There are interchange fees for credit cards. There are check clearing fees when you write a check that we are not aware of. There are costs to print currency when we use money.

Senator BENNET. Let us stick with credit cards, though.

Mr. ZYWICKI. So we have a general sort of problem with respect to consumers who never bear the full cost of whatever their payment mechanism is. And so I would ask the question, if we are going to insist on making it more transparent for credit cards, should we also make it more transparent when you write a check or when you use a dollar bill, the full cost that goes into processing those transactions, and how exactly would consumers be better off? It is not clear to me that consumers would be better off if we forced revelation of that information for every payment device that they use.

Senator BENNET. I don't know, maybe we should, but I think that what I have heard from the small businesses in my State is that this is an enormous cost of doing business. Obviously, the convenience of having customers use credit cards is important to them, as well. But when we are talking about the consumers being able to make choices in a marketplace and some of the most important information is actually obscure to them and there is not any way in the present environment for them to know what the true cost really is, I think that is a problem. And so I would like to come back to how we would address it, but Mr. Clayton, maybe you would like to respond.

Mr. CLAYTON. Yes, Senator. There are so many issues in there we would be glad to have further conversations with you when time allows for a little bit more conversation, but essentially interchange is a cost of doing business. It is not really any different than the cost of labor, than the cost of turning on the lights, than the cost of paying for cash registers and the like. And as a practical matter, if you want to disclose all of that to consumers, you can do that. But it is inherent to the business and it is not any different than that.

What we are really seeing here is, and this is our perspective, obviously, and not shared by the merchant community, but the merchant community trying to transfer the costs of this off of their backs and onto the consumers, because as a frank matter, this is something that provides enormous benefit. It provides ticket lift, which means more purchases coming for a merchant. It provides a great deal of security. Remember, as soon as that card is swiped through the machine, all of a sudden, the risk of being paid back moves from the merchant to the lender. Now, all of a sudden, the lender is the one that takes on all that risk of borrowing and all

that risk on the debit card side and everything, whether they will actually have money in the account to pay. So there is a significant risk here to the lender involved.

And I want to stress something, too. This is an every-bank issue. I mean, every community bank in America that issues a debit card, which is nearly every one of them, uses interchange fees to help support its ability to offer product and services to its local communities. If you go in and snuff out the ability to have any kind of return on this investment and to take those risks, then you are telling them that they cannot be competitive with the largest institutions in America. We think that is a bad idea.

Senator BENNET. Doctor, did you have something?

Mr. AUSUBEL. Mr. Clayton is overstretching a bit in saying that an interchange fee is just like, what did you say, the cost of labor and things like that. The difference is that there is market power to be exercised in setting the interchange fee. The interchange fee is set by Visa, by MasterCard, and a few other select organizations. There is market power there which is not present in most of the other costs facing small businesses.

Mr. CLAYTON. There is, by the way, a consolidated lawsuit in New York to determine whether, in fact, market power has been illegally exercised, and we can determine that. We would argue that it is not the case and that there is competitive pricing in that market, but that court will determine it.

Mr. LEVITIN. Also, the European Union's antitrust enforcement body has actually said that interchange fees are anticompetitive. That is being appealed, but we at least have a broad several countries that have recognized the problems with interchange fees.

I think it is important to note, though, that what Professor Zywicki said is incorrect about interchange fees. There is a serious difference between interchange fees on credit cards and the cost of cash or checks or payment devices like that. If a merchant wants to charge more for cash, that is the merchant's prerogative. The merchant cannot surcharge for a credit card. If the merchant does so, the merchant is violating its agreement with its acquirer bank.

Also, 45 percent of the cost of interchange fees, that is just going to fund rewards programs. Merchants don't get any benefit from that. That is going for frequent flyer miles for rewards junkies. So at least 45 percent of the cost of interchange has really no benefit for merchants.

There is no evidence of ticket lift, contrary to what Mr. Clayton says. If you want to find out how happy merchants are when they have adopted credit cards, talk to McDonald's. McDonald's adopted credit cards thinking that they would get some ticket lift. Everything I hear is they have not been real pleased with it, but they have had to sink in a lot of money and that they are kind of trapped in that now.

Mr. ZYWICKI. May I have an opportunity to respond briefly?

Senator BENNET. I am out of time, so it is up to the Chairman.

Chairman DODD. Respond briefly, if you will.

Mr. ZYWICKI. The issue is whether or not consumers are paying the full cost of the transaction that they are using, and the fact is, when a consumer writes a check, that is subsidized by the Federal Reserve. When a consumer uses cash, that currency is printed by

the government. So every payment device has a subsidy somewhere in it. Sometimes it is the Federal Reserve. Sometimes it is printing currency. And so the issue I was referring to is whether or not consumers are subsidized in their transaction device, not the particular issue that Professor Levitin responded to.

Chairman DODD. Thank you. One of my concerns about this, and we have had long discussions in the past about interchange fees, it is about a \$48 billion revenue stream this year alone, the estimates are, just from interchange fees coming in. What it does, it creates the climate of sort of the liar loan problem we saw with the residential mortgage market because there, the idea is then the sheer volume of the number of cards out there create a revenue stream, just by the volume of the cards out. And the incentive then to determine whether or not the borrower actually is creditworthy reduces tremendously under this system.

That is one of the concerns I have about it and one of the reasons we ought to have—again, I am not trying to deny someone the access to a credit card, but at least having some responsibility and some understanding of that, that when you have a revenue stream of \$48 billion coming in, on the average, it is 2 percent, I think is the average interchange fee, more or less, coming in. That is a remarkable revenue stream and the disincentive to have some verification of the ability of the consumer to meet those obligations, and that contributes, I think, to that environment, which is important.

Senator Tester?

Senator TESTER. Thank you, Mr. Chairman, and I think it is in order to congratulate you for having a daughter, a 3-year-old daughter that has effectively used a credit card very, very well.

[Laughter.]

Senator TESTER. You know, there have been some comparisons here between using credit cards and buying sweaters, and I think it is OK to make those kind of comparisons, but very seldom when I go home back to Montana do I see three or four sweaters laying on the kitchen table for my kids. This is about—and my concern isn't about adults who know better. I am talking about folks who have been in the business world a bit or the workforce a bit. My concern is about credit card companies that put out an offer that is just too good to be true, and then once the fish is hooked, then the fees go up, people starting getting jerked around, and it is just totally not right. It is simply not right.

There has been talk of several bills here today. I have got another one. I think just about every one of these can be incorporated, not to squash the credit card companies, but quite frankly, when I go home, and they don't know the earning history of any of my kids, and they have got a decent earning history now—and I hope they don't get credit cards because I said that—but the truth is that when they were in college, they didn't have much earnings history. When they were in high school, they certainly didn't have much of an earnings history. Then you go home and there are these credit cards laying there.

So the question is this. It is for Mr. Clayton, because several times today during the testimony, you talked about these are significantly risky loans that are out there. If these really are signifi-

cantly risky loans out there, why is there no requirement for any sort of earnings history whatsoever when you give a person a card, particularly a young person, but it could apply to anybody, and say, here it is. There is a line of credit for X-number of dollars. Go out and have fun.

Mr. CLAYTON. Well, first of all, card companies do look at income and employment history and otherwise to make——

Senator TESTER. Well, just real quick, if they are looking at income and earnings history, I can guarantee you they don't look very doggone deep, because when kids in school, when a 3-year-old daughter gets a credit card application, what kind of earnings history are they looking at?

Mr. CLAYTON. I don't think that 3-year-old daughter actually got a card, nor could they be obligated to pay under that card, so—look, marketing, people get letters because they are on some other lists. It doesn't mean they are going to get a credit card. And so to be real clear, I doubt—Senator, please feel free to correct me—I mean, it is a solicitation and so it is nothing more than an advertisement to apply.

Credit card companies look carefully at trying to cultivate relationships with 18-year-olds, 20-year-olds, 22-year-olds, 24-year-olds, because they recognize they are in for the long haul. They take that responsibility seriously, and in fact, they take special care. They make sure that their minimum limits are actually—their credit limits are low, and they start off typically with a \$500 credit limit and it doesn't grow that quickly. And they work with care to make sure they—and monitor the card account to make sure they don't get into trouble.

One of the things that gets lost in this debate is that, in fact, students perform well in their use of credit cards. There are lots of different studies and different numbers. The numbers that we see are that they perform as well as or if not better than the general population, and they have average balances that are much lower than the general population. So as a practical matter, the vast majority of students are using their cards responsibly and well.

Do people get into trouble? Absolutely. Should we be sensitive to that and figure out better ways to address that? I think we would be willing to work with you and figure out how to best do that.

Senator TESTER. And I appreciate that because I think it does need to be done. The fact is, and I will go back to Senator Brown's comments because he brought it up with the Web site from Ohio State. If, in fact, this is true, then why do we see consumer debt going up for kids, going through the roof? And quite frankly, if we are paying tuition with credit cards, we are heading way, way, way down the wrong road there.

Mr. CLAYTON. And that clearly is an underlying problem that has nothing to do really with the credit card but the underlying cost of——

Senator TESTER. You had a point you wanted to make, Mr. Levitin?

Mr. LEVITIN. Yes. As the Chairman noted, all credit card loans are stated income loans. They are all liar loans. When I get a credit card solicitation, I fill in what my income is, there is no way to check on that. The credit card issuers might look at a credit report,

but that doesn't say what my income is. That only says whether I have been paying past bills. So if they are looking to be repaid from a future income stream, there is no way to tell.

Senator TESTER. Right.

Mr. LEVITIN. And I think it is also—I just want to try and link up two pieces of this, because I think often interchange and the consumer side are seen as separate issues. These are very intimately linked. This is a complete cycle. So interchange funds rewards programs. Rewards programs and teaser rates, those are the honey that lure in the consumer flies into this venus fly trap of sticky interest rates, of hidden fees, and so forth. So if you are concerned about an unsafe and unsound underwriting model, it is not enough just to go out to try and focus on solicitations. You have to look at the entire business model with this.

Senator TESTER. I appreciate that. I want to talk a little bit, and I know that the House Financial Services Committee yesterday had an extensively reported hearing on what is going on with the TARP money. I just want to ask, and I think if there is anybody else that this question applies to, answer, and I don't mean to direct them all to you, Mr. Clayton, but have any of your members raised rates on credit cards that received TARP funds?

Mr. CLAYTON. Let me step back for a second and look at the Fed's recent G-19 report on interest rates, and they basically have shown that interest rates, while they have ticked up a bit, are still approximately 12 percent and are like 136 basis points below what they were a year ago today. And so interest rates are, in fact, on average, relatively low. Are card companies adjusting their interest rates because of the perceived and real risk in the marketplace? Yes.

Senator TESTER. So what you are saying is they did increase the interest rates if they received TARP funds. That was—

Mr. CLAYTON. I don't think that there is more than one relationship. I don't think that has anything to do with the TARP funds. I think they are focusing on the risk in the—I mean, one of the things that gets lost is the complete flexibility and unsecured nature of this product. I mean, I know you look at this as a negative, but also remember there is a positive to this. The flexibility it provides to consumers at two o'clock in the morning when the car breaks down and the tow truck has to take you home, or to pay for some kind of medical service or some kind of treatment for a child if you don't have the money but they need to pay for that is all provided in this little card. And lenders take risks in doing that because people may not pay them back. We talk about liar loans. We are talking about promise loans. These are promise loans made to hundreds of millions of people every day.

Senator TESTER. OK. Go ahead, Travis.

Mr. PLUNKETT. Senator, no one is denying credit cards are convenient and useful for consumers. The question is are their practices fair. I mean, the first thing to say to Mr. Clayton is why are interest rates ticking up when the Federal funds rate has dropped through the floor?

The next thing to say is that many national banks, as you point out, have received TARP financing, and then Secretary Paulson set up and Secretary Geithner says he will expand this new program

called the Term Asset-Backed Securities Loan Facility to support credit card lending. It is not just a question of interest rates. Are the terms fair that will be supported through this program?

Mr. CLAYTON. Let me jump in for a second in terms of answering that first question. Interest rates are not just determined by how much it costs, the Fed prices its loans. Interest rates are determined by lots of other things, including delinquencies in the marketplace, which have gone up, as well as the cost of securitization, where spreads have increased significantly. What that means is investors are demanding more return in order to underwrite or fund card loans.

Senator TESTER. Real quickly, Doctor.

Mr. AUSUBEL. Credit cards are extremely useful, but that is not an excuse for completely opaque pricing. I mean, the whole issue—lots of other products, price competition works better because, first of all, it is easier to figure out the true price that the consumer is paying, and second, the price is predictable. Most other consumer products do not have any-time, any-reason clauses.

Senator TESTER. Thank you. Just very quickly, Mr. Chairman. Thank you very much for holding the hearing. Thank you very much for putting your bill in. I will just tell you that you try to teach the next generation the right thing to do. My parents said, you aren't going to have a credit card, and in the days when I got my first credit card, I paid a fee and the interest rates were pretty clear cut. That has all changed now, I think. I know it has changed.

But I can tell you that I have so many examples of young people under the age of 35 that get a credit card. They use it, they go on a vacation, their payment comes in late, and the fees and the interest rates take up all the money that was going to the principal. I have got to tell you, that is flat not right.

My time has long since run out, but I will just tell you, it is not fair, it is not right, and it is not the way the program should work. People are getting into people's pockets by making it darn easy to sign up with these things, and then if they make one mistake, they put the boots to them.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator, very much.

Senator MERKLEY?

Senator MERKLEY. Thank you very much, Mr. Chair.

Professor Zywicki, I think from your comments I could describe you as an advocate for the—there is a competitive market here between cards. But it has been pointed out by Professor Ausubel that that credit market would be stronger if consumers had the ability to have more transparency to understand the rates better, the terms better, if they weren't so complicated, they didn't have so many hidden ways of charging you later, will you pretty much agree with that, or would you contest that?

Mr. ZYWICKI. Thank you for that. First, Senator Tester is leaving. I will just note that with respect to the cost of credit card operations, the cost of funds are about 30 to 40 percent of total costs. Charge-offs are about 30 to 40 percent, and operating costs are about 20 to 30 percent. So the reason we don't is exactly as Mr. Clayton was saying. The reason is when charge-offs go up and risk

goes up, the amount that goes obviously to charge-offs goes up and so that dampens any interest-rate effect. So I just thought that would be some facts to put on the record.

And I appreciate your question, Senator, because I think it is the most important question here and one that is worth focusing on. This is about complexity, right? These are very complex products. They do have a lot of price points that can confuse consumers. But the reason they are complex is precisely because consumers use these in so many different ways. They use an auto loan to buy a car. They use a mortgage to buy a house. They use a credit card to do a cash advance, to make a purchase, to revolve debt, to travel to Europe, to do all the different sorts of things that they do with it. So there are a lot of price points, but it is precisely because of the myriad different ways in which consumers use these products.

We do need a better way of dealing with this. The market is already ahead of us. There is a new Web site called *Cardhub.com*. I have nothing to do with *Cardhub.com*. What *Cardhub.com* is is a Web site you can go to and you can basically get tailormade disclosures. You could say, I am interested in a card that has no annual fee, low transaction fees for travel to Europe, and gas benefits when I use my card, and they have about 1,000 credit cards in their system and you can basically create a tailormade disclosure for exactly the fees that you are looking for.

What I get concerned about this is that we take a one-size-fits-all proposal and put it on top of a market where consumers are using cards for all myriad sorts of things. So regulation, I hope, can encourage and be a mechanism for encouraging further innovation, development in these cards, and allowing consumers to get what they want.

If I could just add one last fact—

Senator MERKLEY. One quick point. Go ahead.

Mr. ZYWICKI. Sure. One last fact is there has been some talk about fees, interchange fees. Just to kind of get the facts on the record, according to the GAO report, about 70 percent of credit card revenues come from interest. About 20 percent come from interchange fees. And about 10 percent come from fees. The fee amount of 10 percent has basically been constant over time. What we have seen is it used to be 10 percent were annual fees, and now they have gone down. Annual fees have basically disappeared. Late fees and that sort of thing have gone up to 10 percent. So the total amount that are fees has remained about 10 percent. Just the nature of the fees has changed.

Senator MERKLEY. OK. Well, let me get another perspective on this. I will tell you that I use checks in just as many complicated ways as I use a credit card, so I am not particularly persuaded by your argument on that, but let us get another perspective from Professor Ausubel. And could you also address the fee rate, as well, point?

Mr. AUSUBEL. Right. First of all, on fees, it is well documented that the level of fees has gone up at a very rapid pace over the past 10 years. I mean, you can see it very clearly if you just look at any particular fee, like if you look at the level of the late payment fee that was present in the past and you look at the \$39 now.

Mr. ZYWICKI. How about the annual fee?

Mr. LEVITIN. May I jump in, Senator?

[Laughter.]

Senator MERKLEY. Let Professor Ausubel finish and then we will let you jump in.

Mr. AUSUBEL. I am talking about fees in aggregate. What was the next thing?

Senator MERKLEY. Well, the first was the complexity of purchases—

Mr. AUSUBEL. Oh, the complexity. So here is a way to think about the business model in the credit card market. What happens is there is a certain number of terms of the credit card account that people pay the most attention to. So, for example, at a certain point, people might have been paying attention to annual fees. Competition steps in and annual fees get competed down. But simultaneously, the banks add new fees which are not on consumers' radar screens which generate real revenues and which take a while for consumers to catch up to. So if you ask, why has the number of fees multiplied, it is to have new revenue sources that are not on consumer radar screens.

Can I give you one quick example that is unambiguous? Most issuers have 3 percent fees if you purchase anything in foreign currency. Note that there is absolutely no cost associated with this because the currency conversion fees are already built into the whole operation.

Senator MERKLEY. Thank you. I am out of time. Can we allow another person to respond?

Chairman DODD. Please go ahead.

Senator MERKLEY. Mr. Levitin?

Mr. LEVITIN. Yes. I think it is really important to note that while some credit card fees do relate to particular usage patterns, the credit card billing practices that are really problematic have no relationship to the way anyone uses a card. Double-cycle billing? How does—I just can't see how that relates to the different ways consumers use cards. Any time, any reason term changes, the same thing. It is not based on usage patterns. These are just hidden fees—these are billing points that function as hidden fees and don't relate to the way consumers actually use cards. They just relate to an ability to snooker consumers in with low teaser rates and then whack them over the head with back-end fees that they aren't expecting.

Mr. STURDEVANT. Senator—

Senator MERKLEY. My time has expired.

Mr. STURDEVANT. I had one point—

Chairman DODD. Go ahead.

Mr. STURDEVANT. There is no more complexity in how consumers use cards today than there was in 1964 when Bank of America introduced them except that we have the Internet now. People make purchases in the same way, in the same variety of ways, and as Senator Tester, I believe, pointed out, in 1964—and the Chairman did, as well—you had a membership fee, maybe, and you had an interest rate.

And that is how the product was marketed until the late 1970s when interest rates hit an historic high of 21 percent and the credit card industry said, we can't make any money. We can't make

money anymore from the interest rate to the customer and the interchange fee. So all of a sudden, we had the introduction of the over-limit fee and the late payment fee. And then as time went on, we had more and more fees, the access fee, the quick look fee, the returned check fee, the administrative fee, the extra card fee, *et cetera, et cetera, et cetera*.

As interest rates came down—interest rates were very slow to come down in credit cards and none of the fees went away. The only thing that happened is that the amount of the dollars increased sharply. So in 1996, the credit card industry earned \$1.7 billion in penalty fee revenue. In 2004, it earned \$14.8 billion. If you combine penalty fees, cash advance fees, and annual fees, those three items alone, that reached nearly \$25 billion in 2004, and they were sitting in the Dirksen Building and Senator Dirksen was famous for his remark that a million here and a million there, we are talking about real money. In today's climate, a million is nothing and even a billion seems to be nothing. But where I come from, \$25 billion is a significant revenue stream.

As we have heard today, credit card companies have engaged in conduct to create late payments, to prevent timely payments, to receive the payment and not post the payment, anything it can do to trigger that. With respect to over-limit transactions, the credit card companies through its systems totally control usage. They want over-limit transactions so long as the customer continues to make a payment, and they use the \$39 fee when the customer calls to complain to enable the company to raise the credit limit so that there is more debt out there so that the minimum payment is higher on that dollar value.

But nothing principally has changed in the marketplace since 1964 except the escalation of the types of fees and the amount of dollars imposed on those fees.

Mr. CLAYTON. Senator, I know I am belaboring the point here. I would say that GAO in a 2006 study basically said that total aggregate fees, comparing 1990 to 2004, remained relatively stable, meaning they didn't change. There was a transfer from annual fees to these other types of kind of transaction fees, all of which were basically transferring a fee that a consumer had no control over, an annual fee, versus one—late fees and other things, over-limit fees—that they have some control over.

Chairman DODD. I appreciate the point. I mean, an annual fee, that is in terms of the pricing points, that when you pay an annual fee, you know what it is. The question then of when these additional fees kick in, how they kick in, has been the source of the contention. In too many cases, they appear to be for reasons that should be unrelated to the performance of the consumer when it comes to the credit card, and we have talked about them before, the universal default issue, the double-cycle billing. Now, some of these have been changed, I agree with the things, but clearly these fees were not ones that a consumer can price necessarily when they increase them in ways that seem not terribly relevant to the behavior by the consumer.

I don't think anybody is suggesting that when a consumer behaves poorly, if you will, in this matter that there are obviously going to be charges associated when that occurs. The question is,

it is not so much performing poorly but rather what appears to be, I say to you, that designs to rather get around the fact, because the annual fee wasn't producing the kind of revenues. The competition reduced it, so what other ways can we do this, to find that?

And obviously, look, marketing—I know this is probably true no longer, but there was a while not long ago when the parlance of the industry, if you were someone that paid off whatever the obligations were on a monthly basis, you were called a deadbeat, because frankly, you weren't very good financially. Someone who pays that thing off every month, you are not making much money off of them.

The ideal consumer is someone who is paying the minimums here each month because that person is going to pay a lot more for that service or product over an extended period of time than the person who pays it off immediately. And it seems to me that by marketing to a lot of people, in a sense, who are in that situation, obviously raises certain concerns.

Again, I have got credit cards. I understand the value of them, the importance of them for people, and I want the industry to know this is not a hostile situation we are talking about. We are talking about trying to make it work right for people in a sense at a time of great difficulty, when people are feeling a tremendous pinch.

And obviously we have got securitization of this industry, which is another incentive in a way. If you are able to securitize that debt and sell it off someplace, then the incentives for you to want to manage it better are reduced, much as it was in the residential mortgage market. When you can securitize that product and sell it, your interest in having underwriting standards and so forth and to demand greater accountability begin to diminish significantly, and this has been a significant problem.

In fact, it is one of the problems the banks have, because they are looking down the road and they are seeing a lot of this debt coming at them, not only in commercial real estate, but also in student loans and in credit card obligations. So obviously one of the reasons they are not lending a lot, I suspect, is because they recognize they have got these obligations coming.

Why are they coming? Because they market a lot of products to people who couldn't afford them, in a sense. And had they done a little more work and determined whether or not that person out there was actually going to be able to meet those obligations instead of basically giving them out to anybody and everyone, then we wouldn't be facing this situation, much as we are facing in the residential mortgage market. There are distinctions, obviously, between a mortgage and a credit card obligation, but nonetheless, a little more adherence to those principles would reduce the very problems we are looking at in real estate as well as in commercial transactions such as credit cards.

So it is sort of a self-fulfilling prophecy, in a way, we are dealing with in this issue. There is less accountability, marketing to more people who can less likely afford the obligations. Obviously, a lot to be made off of it because obviously someone who has to pay every month something on that over a long period of time increases tremendously the amount they will pay for that.

That is why I disagree with you, Mr. Zywicki. I know you don't—I don't disagree with your point, the point I think you were making. I think there is some legitimacy to this. If you load up a load of consumer warnings, there is a point at which no one reads any of it. It is like on prescription drugs or something, or over-the-counter stuff. You begin to read so much that you just—you can't remember any of it.

But I do think the idea of saying to people, let me show you that if you purchase a product and make just the minimum monthly payment on this, how much more you are likely to pay for a product, I think that warning to a consumer has value. If you know that, I think you are going to have second thoughts that that item doesn't cost \$50, but it is rather going to cost you \$150 by the time you are through with it. It has a value. And I don't disagree that if you load it up with a lot of stuff, no one reads any of it, but I think it is an important point.

I raised the issue on the securitization and I wonder if you—I will raise the question if any of you want to respond to it. The securitization of credit card loans permitted companies to engage in at least lending practices that are less vigilant. Mr. Clayton, what about that?

Mr. CLAYTON. Securitization was engaged in to lower the cost of borrowing so that we could lower the cost of credit.

Chairman DODD. But doesn't it also basically—in other words, the incentive for the issuer to make sure that the borrower is going to be more creditworthy diminishes when you know you are going to be able to sell that debt off. Isn't that also true?

Mr. CLAYTON. There is a significant difference between credit card securitizations and mortgage securitizations. Mortgage securitizations involve, as I understand it, a great deal of pooled loans from a lot of different issuers and underwriters. Credit card loans, they come from one company and that company's reputation and cost of future issuances is dictated by the performance of that underlying securitization.

Chairman DODD. Yes.

Mr. CLAYTON. So as a practical matter, it is—they hold the risk, and if these trusts unwind, that comes back on the balance sheet. So there are real risks and checks and balances, which is what I think you are referring to, in this area. If the marketplace believes that this doesn't work, the cost of borrowing for that company goes up significantly. So there are real prices to be paid.

Chairman DODD. Anyone else? Yes, Mr. Levitin?

Mr. LEVITIN. There is another significant difference between credit card and mortgage securitization. Mortgage securitization, a typical securitization deal, the originator sells off the loans and has no further interest in them. That is not, as Mr. Clayton points out, that is not what happens with credit cards. The card issuer retains essentially the residual interest. Every month, if after—if the cards generate enough income to pay off all the mortgage-backed security bonds, anything left over goes to the card issuer. That is called the excess spread.

What this means is that the card issuer holds all the upside, but it has sold off most of the downside to investors. This gives card issuers an incentive to apply more late fees and over-limit fees be-

cause that will result in some people defaulting on the debt entirely, but others, it will result in them paying more. This increases volatility. For credit card securitization, the more volatile the accounts are, that all accrues to the benefit of the issuer, and the downside of the volatility goes to the investors.

Chairman DODD. Yes, Mr. Ausubel?

Mr. AUSUBEL. I would generally agree with what has been said. I mean, that securitization in the credit card market is fundamentally different than the mortgage market because the credit card issuer remains the residual claimant in the whole business operation.

The place where you can find some similarity is that when consumers get distressed, there are some parallels between it giving bad dynamics in one market than the other. I mean, so you have been hearing on the mortgage market you have this problem that the whole system may be better off because—the whole system may be better off if there were some forgiveness, like you modify the terms. When we securitize it, you have one group of people who own the mortgage, another set of people who service the mortgage. The people who service the mortgage may not want to relax the terms because it is not in their benefit.

You have the same thing in the credit card market with universal default and that sort of thing, that if a consumer gets into trouble, all the banks, the entire system may be better off if there were some forgiveness, but instead what each bank does is they try to load up what is owed to them and they try to collect as rapidly as possible from the consumer before the consumer goes bankrupt. So you have the same sort of divergence of interests which leads to a sub-optimal level of forgiveness.

Chairman DODD. Well, listen, this has been very worthwhile, and Mr. Clayton, I appreciate very much your being here. You know the industry obviously very well and I speak with some frequency to obviously my own bankers in Connecticut and others who have strong views on the issue, as well. My interest is doing something balanced and responsible as we move forward.

I am concerned about the lateness of this July effective date in terms of what happens between now and then, and regulations and rules, while they are important and they are not insignificant, statutory changes have a way of bringing more permanency to a process than obviously the vagaries of rulemaking, which can be undone pretty quickly. And so there is a reason, I think, if we can come to some common understandings about some of these points here, that we will be all better off in some ways.

But I think all of us up here—I believe all of us up here—have no interest in destroying the credit card industry. We realize the value of it and the importance of it, and I think it is a very important point to take away from a hearing like this, how best we do that.

And going back to the point that I hope we learned, because we certainly got away from it, and I am sounding like a broken record on this point, but for too long, I think there was the assumption that consumer protection laws were more than just an annoyance. They were antithetical to the notion of economic growth and prosperity. And we have learned painfully over the last several years

how dangerous that mentality is, that, in fact, had consumer protection been very much on the minds of people, on regulators and others, we wouldn't be in the mess we are in today. This was not a natural disaster. This is one that was avoidable.

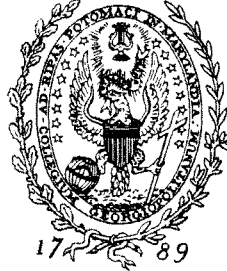
And so it is very important, if we learn anything out of all of this as we try to get back on our feet again, is that that notion of consumer protection ought not to be seen—there are unintended consequences. Bob Corker makes a legitimate point. You want to be careful how you proceed in all of this. But the notion once again that we could ever start thinking about regulation, reform, and creating new architectures for the 21st century, very much a part of that has to be that that end user, that consumer user of products, be they credit cards, mortgages, car loans, student loans, they have got to be paramount in our minds. And when they are, then we have strong economies that grow well, create wealth, create prosperity. When we avoid it and subjugate it or reduce it in its importance, then I think we get ourselves into the kind of mess we have seen recently.

So I am very grateful to all of you for your testimony today. We will leave the record open. I am sure there are members who may have some additional questions. You may have some additional information and material you think it would be worthwhile for us to consider in our discussions here as we go forward and we will certainly leave the record open for that.

With that, the hearing stands adjourned. I thank you.

[Whereupon, at 12:28 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions follow:]



GEORGETOWN UNIVERSITY LAW CENTER

Adam J. Levitin
Associate Professor of Law

Written Testimony of

Adam J. Levitin
Associate Professor of Law
Georgetown University Law Center

Before the
United States Senate
Committee on the Banking, Housing, and Urban Affairs

Hearing on:
Modernizing Consumer Protection in the Financial Regulatory System: Strengthening
Credit Card Protections

February 12, 2009

WITNESS STATEMENT

Adam J. Levitin is an Associate Professor of Law at the Georgetown University Law Center, in Washington, D.C., where he teaches courses in payment systems, bankruptcy, and secured credit and directs the Georgetown-Hebrew University in Jerusalem Executive LLM Program in Business and Commercial Law. Before joining the Georgetown faculty, Professor Levitin practiced in the Business Finance & Restructuring Department of Weil, Gotshal & Manges LLP in New York. He also served as law clerk to the Honorable Jane R. Roth on the United States Court of Appeals for the Third Circuit.

Professor Levitin's research focuses on financial institutions and their role in the consumer and business credit economy, including credit card and mortgage lending and servicing, identity theft, DIP financing, and bankruptcy claims trading. He is a regular commentator on *Credit Slips*, a blog devoted to credit and bankruptcy issues, and is the winner of the 2007 Editors' Prize of the *American Bankruptcy Law Journal* and the 2009 Article Prize of the American College of Consumer Financial Services Lawyers.

Professor Levitin holds a J.D. from Harvard Law School, an M.Phil and an A.M. from Columbia University, and an A.B. from Harvard College, all with honors.

Professor Levitin has not received any Federal grants nor has he received any compensation in connection with his testimony. Professor Levitin does not represent any party in connection with any credit card regulatory issues.

Mr. Chairman, Ranking Member, Members of the Committee:

I am pleased to testify in support of the Credit Card Accountability, Responsibility, and Disclosure Act and other legislation that would create a more efficient and fair credit card market and encourage greater consumer responsibility in the use of credit.¹ There are four major points I wish to make in my written testimony:

(1) Consumers cannot use credit cards efficiently and responsibly because the price of cards is not transparent, due to the unnecessary and deliberate complexity of credit card price structures and billing practices. Lack of transparent pricing cost American consumers over \$12 billion in unnecessary interest and fees in 2007.²

(2) Opaque pricing, including billing tricks and traps, are an essential part of the card industry's fee-based business model that encourages unsafe lending practices. Eliminating billing tricks and traps is an important step to ensuring sound underwriting in the credit card market and reducing systemic risk.

(3) The current regulatory regime for credit cards is inadequate and incapable of keeping pace with card industry innovation. The agencies with jurisdiction over credit cards lack regulatory motivation and have conflicting missions and those with motivation lack jurisdiction. Congressional action is necessary not only to address the current problems in the card industry, but also to create a federal regulatory agency with authority and motivation to regulate the card industry on an on-going basis.

(4) "Risk-Based Pricing" is not a valid reason to refrain from regulation of the credit card industry. The card industry does not engage in meaningful risk-based pricing.

(a) The risk premium is only a minor component of credit card pricing, and the card industry's ability to refine risk premiums has had only a marginal impact on the total cost of credit or its availability. Total costs of credit have remained essentially static, while the growth of credit availability is due to the shift to a fee-based business model, as issuers are happy to lend when someone else holds the credit risk, just like in the mortgage market.

(c) The risk premium is pool-based, rather than individually underwritten, so cross-subsidization concerns are weak. Instead, the pool-based underwriting of credit cards calls for the adoption of key features of insurance regulation: standardized contracts, term prohibitions and requirements, and on-going licensing.

¹ This testimony derives from Adam J. Levitin, *A Critique of the American Bankers Association's Study of Credit Card Regulation*, Georgetown Law and Economics Research Paper No. 1104327, at <http://ssrn.com/abstract=1104327>. All source data for graphs in this testimony may be downloaded from <http://www.law.georgetown.edu/faculty/levitin/documents/ABADATA.xls/>.

² Comment Letter 177, Unfair or Deceptive Acts or Practices (2008-0004), from Oliver Ireland, Partner, Morrison & Foerster LLP, dated August 7, 2008, available at <http://files.ots.treas.gov/comments/bdc5cc5c-1e0b-8562-cb23-ff7159e49505.pdf>. The letter does not address on whose behalf Mr. Ireland is writing, but Mr. Ireland is a prominent credit card industry lobbyist.

I. CONSUMERS USE CREDIT CARDS INEFFICIENTLY AND IRRESPONSIBLY BECAUSE THE PRICE OF CREDIT CARDS IS NOT TRANSPARENT

It is a bedrock principle of economics, the price theory of demand, that demand is a function of price. When prices go up, demand goes down, and vice versa. This is what makes markets work. But in order for markets to work, prices must be transparent. Consumers must be able to accurately gauge the costs of a product in order to calibrate their demand. If consumers cannot accurately gauge the costs of a product, they will not use the product efficiently or responsibly. They will over-use it or under-use it. And if consumers cannot accurately gauge the costs of competing products, they might use the wrong product altogether. Inefficient use of products is a problem deserving regulatory intervention when it imposes costs on society in general.

The price of credit cards is not transparent to consumers. Credit cards are different from virtually every other consumer financial product in their complexity. Most consumer credit products, such as auto loans, mortgages, and student loans have only one or two price points. These price points do not vary except in relation to an objective index, such as the Federal Funds Rate or LIBOR. Unlike other common consumer credit products, however, credit cards have an astounding array of price points: annual fees, merchant fees, teaser interest rates, base interest rates, balance transfer interest rates, cash advance interest rates, overdraft advance interest rates, default interest rates, late fees, overlimit fees, balance transfer fees, cash advance fees, international transaction fees, telephone payment fees, etc. These are all explicit prices points, disclosed in Truth-in-Lending schedules.

The sheer number of explicit prices points that make it difficult for consumers to accurately and easily gauge the total cost of using credit cards.³ Consumers are not capable of doing the on-the-spot calculations necessary to figure out whether or not to use any particular credit card for any particular transaction. There is too much information that the consumer must process, including information that the consumer cannot know at the time the card is used, such as when a payment will be credited. Even if the consumer had perfect information and could process it all, it simply would not be worthwhile to do for every transaction. The burden this would impose would negate all of the convenience benefits credit cards have for consumers.

Consumers' difficulty in determining the cost of credit cards is compounded by credit cards' hidden price points in the form of billing practices, such as universal cross-default, unilateral term changes, residual interest, two-cycle billing, unlimited overlimit fees, application of payments to the lowest interest rate balance, non-standard use of terms like "fixed rate" and "Prime rate," and unclear policies as to precisely when a payment is due. These billing practices make credit card pricing to vary based not only on objective indices, but also on the card issuers' subjective whim.

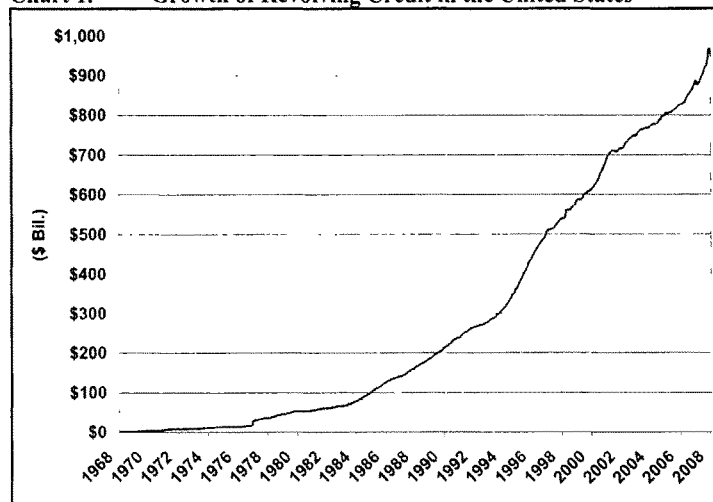
Credit card billing practices alter the application of the explicit price points and make the effective cost of using credit cards higher than disclosed. What is especially problematic about credit card billing practices is that they alter the cost of credit *after the consumer has already committed to using the card* and not in transparent, predictable

³ Mark Furletti, *Credit Card Pricing Developments and Their Disclosure*, Discussion Paper, Payment Cards Center, Fed. Res. Bank of Phila., Jan. 2003, at 19.

ways that the consumer could account for at the time the card is used. Credit card billing practices further obfuscate the true cost of using credit and make it virtually impossible for a consumer to make a fully informed decision about whether to use credit and, if so, which credit card product to use.

By concealing the true cost of using credit cards, these billing practices lead to inefficient and irresponsible credit card use. In particular, when consumers underestimate the costs of using credit cards, as occurs when consumers do not notice hidden price points, they will overuse credit cards. Accordingly, unfair and deceptive credit card billing practices have contributed to the soaring level of consumer card debt, which is rapidly approaching one trillion dollars (see Chart 1, below).

Chart 1. Growth of Revolving Credit in the United States



Source: Federal Reserve Bank Statistical Release G.19.⁴

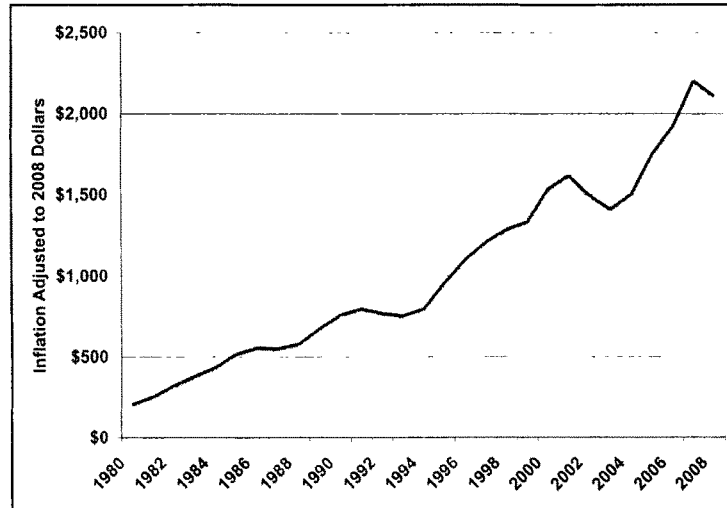
The overleveraging of consumers due to inefficient credit card usage caused by non-transparent pricing hurts the economy and society and is not sustainable. The higher levels of credit card debt service fostered by hidden price points in credit card billing practices come at the expense of other parts of the economy, as every dollar spent paying off credit card debt is a dollar that cannot be spent on new goods and services.⁵ As Chart 2 shows, even in inflation adjusted dollars, the amount of interest US households pay on revolving debt (almost all of which is credit card debt), has grown significantly and is

⁴ Federal Reserve Statistical Release G.19 measures revolving credit, which is primarily, but not exclusively credit card debt. Mark Furlletti & Christopher Ody, *Measuring U.S. Credit Card Borrowing: An Analysis of the G 19's Estimate of Consumer Revolving Credit*, Fed. Res. Bank of Phila. Discussion Paper, April 2006, at 24. There is no governmental statistic measuring just credit card debt, much less credit card debt accruing interest, a serious shortcoming in the Federal Reserve's statistical collection.

⁵ Adam J. Levitin, *Priceless? The Social Costs of Credit Cards*, 45 HARV. J. ON LEGIS. 1, 46 (2008).

now at over \$2,000/year. These high levels of credit card debt also discourage savings for future contingencies and retirement.

Chart 2. Interest Paid on Revolving Debt Per Household



Source: U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Products Accounts, Table. 2.1.1, Line 29.

For the average American family, the impact of these billing practices on household finance is staggering. The Pew Charitable Trusts calculates that a single credit card penalty repricing on a balance of \$3,500 is re-priced, the additional interest can consume one-quarter of an average household's discretionary income during a year.⁶ As Pew notes "Though positioned [by the card industry] as necessary to encourage responsible payment behavior, penalty re-pricing practices today can have severe and sometimes devastating effects upon household finances."⁷ The card industry itself estimates that just a handful of billing practices accounted for \$12 billion dollars in additional revenue.⁸ Eliminating these hidden price points will help the economy overall by putting more than \$12 billion dollars back in the pocket of consumers, which can be used for productive consumer spending.

Disguised credit card price points also contribute to bankruptcy filings. Concealed pricing encourages higher credit card use than would otherwise occur, which leads, inexorably, to more credit card debt. Dollar for dollar, a consumer with credit card

⁶ Letter from R. Dwane Krumme, General Manager, Credit Card Standards Project, The Pew Charitable Trusts, to Mr. Leonard Chanin, Assistant Director, Division of Consumer & Community Affairs, Board of Governors of the Federal Reserve System Re: Docket No. R-1314, dated Oct. 3, 2008.

⁷ *Id.*

⁸ Ireland, *supra* note 2.

debt is more likely to file for bankruptcy than a consumer with any other type of debt.⁹ Debt is of course a *sine qua non* of bankruptcy, but credit card debt has a particular and peculiar relationship with bankruptcy filings that other types of debt do not have. Banning unfair credit card billing practices may help limit bankruptcy filings, the costs of which are borne by all creditors, including the government, and thus by all taxpayers.

Because of the serious social costs of credit card billing practices and the inherent unfairness of many of them, Congress should act to make the credit card market more efficient and to encourage greater consumer responsibility by banning credit card billing practices that function as covert price points and mask the true cost of credit. Banning these billing practices would bring much needed transparency to the credit card market.

By banning billing practices that function as covert price points, Congress can promote greater competition in the card industry, help consumers exercise control of their finances responsibly, encourage productive consumer spending, and help decrease bankruptcy filings. Currently credit card issuers do not compete with each other on the net price of cards (benefits minus costs). Instead, they compete on selectively highlighted price points, such as teaser interest rates or bundled benefits, like frequent flier miles.¹⁰

Any card issuer that attempted to advertise its total price would suffer in the market because its total price advertisements would line up against the zero percent teaser rates and triple bonus miles offered by other issuers. It is easier for issuers' to push price points away from easily comparable, up-front costs, like annual fees, toward delayed back-end price points like penalty interest rates, late fees, and overlimit fees. Competition within the card market leads to obfuscated pricing with price points hidden away in fine print billing practices. Eliminating hidden price points encourages card issuers to compete on the basis of *total* price, which will make the credit card market more efficient.

Banning abusive billing practices will also empower consumers to exercise control of their financial affairs responsibly, both by making the price of credit more easily understandable and by permitting cardholders to opt-out of certain rate increases and opt-out of the ability to exceed their charge limit.

Eliminating hidden credit card prices points will make credit card markets more efficient and will help consumers and the economy.

II. BILLING TRICKS AND TRAPS ARE AN INTEGRAL PART OF A CREDIT CARD BUSINESS MODEL THAT ENCOURAGES UNSAFE AND UNSOUND LENDING

The complexity of credit card billing is not accidental. Instead, it is a key component of the card industry's business model. These tricks and traps directly generated over \$12 billion in revenue for the card industry in 2007,¹¹ which was over

⁹ RONALD J. MANN, CHARGING AHEAD: THE GROWTH AND REGULATION OF PAYMENT CARD NETWORKS AROUND THE WORLD 66 (2006).

¹⁰ Adam J. Levitin, *Priceless? The Competitive Costs of Credit Card Merchant Restraints*, 55 UCLA L. REV. 1321 (2008).

¹¹ Ireland, *supra* note 2.

30% of the industry's pre-tax profits.¹²

Historically, the credit card industry was about lending money and making a profit based on interest rates. The card industry has changed, however. Increasingly, the card industry's business model is fee-based, not interest based. Unfortunately, just as with subprime mortgages, the fee-based business model creates a perverse incentive to lend indiscriminately and ignore delinquencies.

Card issuers make money on every credit card transaction, regardless of whether the consumer ultimately pays a finance charge. The issuer receives around two percent of every transaction in a fee paid by the merchant (and passed on to all consumers in the form of higher prices), called the interchange fee.¹³ Card issuers will collect about \$48 billion in interchange fees this year.¹⁴

Because interchange is based on transaction volume, it creates an incentive for banks to issue as many cards as possible, regardless of the creditworthiness of the borrower. By creating a huge revenue stream unrelated to credit risk, interchange encourages card issuers to engage in reckless lending – and virtually every credit card loan is a “liar loan” with no income verification.

Banks have compounded this problem by shifting much of the loan risk to investors through securitization. When card issuers securitize credit card debt, they transform the credit card debt into a pool of assets used to pay off bonds. If the pool turns out not to be large enough, the bond investors take the loss. But if there's a surplus, it goes to the card issuer.

While card issuers sell off most of the default risk, they keep any upside that comes from inflating their fees and rates. This is a heads I win, tails you lose situation and leads the banks to increase fees and interest rates on securitized debt. If the higher fees and rates cause more defaults, it is investors who bear the loss. If the higher fees result in more income, however, it is the card issuer, not the investors, who benefit.

The billing tricks and traps are used to ensnare consumers in these fees, the card companies deploy numerous billing tricks and traps. When card issuers are able to keep the upside and avoid much of the downside risk on cards, it creates an inherently unsafe and unsound lending practice. Eliminating the billing tricks and traps are the first place to start to curb the systemic dangers of this reckless credit card lending.

III. CONGRESS MUST CREATE A REGULATORY SYSTEM CAPABLE OF KEEPING PACE WITH INNOVATION IN CONSUMER FINANCIAL SERVICES

Banning these abusive and unfair billing practices is an important first step in restoring efficiency, fairness, and responsibility to credit card markets and reducing systemic risk. But it is not enough for Congress to prohibit certain enumerated credit card practices. The card industry has shown itself to be remarkably resourceful in engineering its products around regulation. This means that regulatory initiatives aimed

¹² CardData.com (subscription data source).

¹³ Technically, the interchange fee is the fee paid by the merchant's bank to the issuer, but this fee is simply passed along to the merchant as is the bulk of the “merchant discount fee.” See Levitin, *supra* note 10.

¹⁴ Merchants Payments Coalition

at specific practices inevitably devolve into a game of regulatory Whac-A-Mole: every time regulators put the kibosh on one practice, the card industry invents another to take its place. Congress will always be playing catch-up in this game of regulation and innovation. The only way to stop this negative innovation is to flip the regulatory model on its head. Currently card issuers are allowed to do anything, except specific prohibited practices. The better regulatory structure would be to prohibit anything, except for specific permitted practices.

Congress is not well-suited for determining whether every innovation of the card industry should be permitted or not; the better solution would be to vest a federal regulatory agency, such as the Consumer Financial Product Safety Commission proposed by Professors Elizabeth Warren and Oren Bar-Gill,¹⁵ or the FTC, as proposed by Professor Heidi Schooner,¹⁶ with the power to license card issuers and regulate their practices.

IV. THE MYTH OF RISK-BASED CREDIT CARD PRICING

An important argument put forth by the credit card industry against any form of regulation is that it would negate the benefits of risk-based pricing.¹⁷ Risk-based pricing means that credit cards are priced according to individual consumers' creditworthiness. Credit card issuers contend that since the early 1990s they have engaged in risk-based pricing. Card issuers claim that risk-based pricing has benefited creditworthy consumers in the form of lower costs of credit and subprime consumers in the form of greater availability of credit. Card issuers contend that any regulation, including of their billing practices, would negate the benefits of risk-based pricing.

I wish to highlight four problems with the card industry's risk-based pricing story: (1) the risk component of credit card pricing is trivial, (2) credit card pricing does not reflect individual consumer risk, (3) risk-based pricing does not explain unfair and deceptive billing practices, and (4) neither creditworthy consumers nor subprime consumers have not benefited from putative risk-based pricing.

A. The Risk Component of Credit Card Pricing Is Trivial

Credit card pricing has four components: cost of funds, cost of operations, risk premium, and opportunity premium. These are not equal components. The cost of funds accounts for approximately 25% of the total cost of credit cards.¹⁸ Operating costs—overhead, solicitations, customer service, advertising, etc.—account for around 60% of the total cost of cards.¹⁹ The remaining 15% is a combination of a risk-premium and whatever opportunity-premium that the card issuer can extract. Thus, the risk premium

¹⁵ Elizabeth Warren & Oren Bar-Gill, *Making Credit Safer*, 157 U. PA. L. REV. (2008).

¹⁶ Heidi Mandanis Schooner, *Consuming Debt: Structuring the Federal Response to Abuses in Consumer Credit*, 18 LOYOLA CONSUMER L. REV. 43 (2005).

¹⁷ E.g., Jonathan M. Orszag & Susan H. Manning, *An Economic Assessment of Regulating Credit Card Fees and Interest Rates*, Commissioned by the American Bankers Association, October, 2007.

¹⁸ FDIC Quarterly Banking Profile, Sept. 2008, at <http://www2.fdic.gov/qbp/2008sep/qbp.pdf>. According to the FDIC, the average yield on credit cards in 2008 was 11.99%, and the average cost of funding was 3.05%. This means that approximately 25% of the price of credit cards is attributable just to the cost of funds.

¹⁹ Glenn B. Canner & Charles A. Lockett, *Developments in the Pricing of Credit Card Services*, 78 FED. RES. BULL. 652, 655 n.8 (1992).

accounts for at most 15% of the cost of credit cards. That means for the average credit card assessed interest in November 2008, no more than 200 basis points of the 13.6% APR was attributable to a risk premium.²⁰

As it turns out, however, almost all of this 15% is opportunity pricing. The relative importance of opportunity pricing and irrelevance of risk premiums can be seen from a quick perusal of my own credit cards demonstrates that the pricing has little to do with risk. I have four general purpose credit cards in my name, three from JPMorgan Chase and one from Citibank. Although I am the exact same borrower, with the exact same risk profile, there are four different APRs on the cards, as shown below.

Card	Interest Rate	Credit Limit
Chase 1	0.00% (1-year teaser)	\$12,500
Chase 2	9.24%	\$40,000
Chase 3	13.24%	\$6,500
Citibank	16.99%	\$13,600

Even leaving aside the 0.0% APR teaser rate, Citi is charging a rate that is 83% higher than Chase's lowest rate, and there is a 42% difference in the rates charged by Chase. This shows is that almost one third of the interest rate on my 13.24% APR Chase card and nearly half of the interest rate on my 16.99% APR Citi card have *nothing* to do with risk and are pure opportunity pricing. Between cost of funds, costs of operations, and opportunity pricing, there is almost no room left for risk-based pricing.

Only a very small component of the cost of credit cards has *anything* to do with risk. And, as it turns out, it has only a tenuous connection with the individual cardholder's risk.

B. Credit Card Pricing Has Little Relationship to Individual Cardholders' Risk

As sophisticated as the card industry is, it is incapable of doing individualized risk-based pricing. Its data sources and modeling capabilities are insufficient for individually-tailored risk-based pricing. Instead, consumers are priced by pools based on common characteristics, as in insurance underwriting. The statistical methods used by card issuers to place consumers in pools, known as "neural networks" are inherently limited in their predictive accuracy and cannot account for unusual economic shocks or any of the other unpredictable vagaries of consumer behavior and life. After cardholders are lumped into various risk buckets, the underwriting is done on the general characteristics of that bucket, not by the individual characteristics of the cardholder. While dividing consumers into multiple risk buckets is certainly superior to one-size-fits-all pricing, it is still quite imprecise.

The card industry's inability to price for individualized risk is reflected in the structure of credit card pricing. Only some components of credit card pricing could possibly relate to cardholder risk, and imprecisely so at that. Of the astounding array of explicit and covert credit card price points, only some interest rates and late fees are arguably risk-based. Most have no relation to risk.

²⁰ Fed. Res. Stat. Release G. 19.

There are two factors in determining cardholder repayment risk. First is the size of the cardholder's balance. The second is likelihood of the cardholder not repaying the balance (the "risk profile"). All else being equal, a cardholder with a large balance presents a greater risk to a card issuer than one with a smaller balance because in the event of a default, the card issuer's loss will be greater for the cardholder with the higher balance. It is important to remember that risk profiles, derived largely from credit reports and "on-us" payment history, are not the sole factor in determining risk to the card issuer; fully risk-based pricing should account for both the likelihood of default *and* the size of the issuer's exposure. Only some components of credit card pricing relate to either one or the other of these two risk components, and imprecisely so at that.

None of the many credit card interest rates vary depending on the size of a consumer's balance. On the fee side, only overlimit and late fees sometimes vary depending on the size of a consumer's balance, but even then it is within two or three tiers that do not permit for precise tailoring to risk. Likewise, some interest rates and late fees depend in part on issuers' perception of individual cardholders' default risk, but again are not narrowly tailored.

1. Interest Rates

Credit cards carry a variety of interest rates. Many cards have introductory teaser rates, often at 0%. They also typically have a base rate for purchases, a base rate for cash advances, a base rate for balance transfers, a base rate for overdraft advances, and a default or penalty interest rate. Introductory teaser rates, which typically last several months, are not risk-based; they are flat 0% rates for all borrowers, regardless of their risk.

Although the base interest rate for purchases is only one of many price terms that affect the total cost of revolving a balance on a credit card, it is often perceived as the most important price point; it is the first term listed in the Schumer Box and in larger font than any other term in the Schumer Box.²¹ Base interest rates are not particularly sensitive to individual consumers' evolving risk profiles.

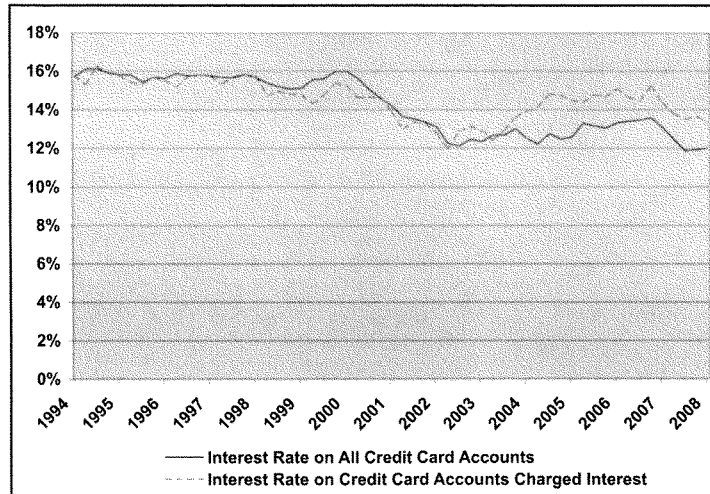
Most issuers offer only two or three pricing tiers for non-introductory base interest rates. Credit risk, however, does not come just in sizes small, medium, and large. These rates do not change with the percentage of the cardholder's credit limit that is used, even though there is a greater risk posed by identical cardholders, one of whom has a balance of \$200 and another with a balance of \$20,000. Base interest rates do change, however, with the cardholder's risk profile (excluding balances). When a consumer's risk profile changes, based either on "on-us" events, related to the cardholder's use of the card or other services from the issuer or on "off-us" events, related to the cardholder's other credit behavior, many card issuers apply default and penalty interest rates retroactively to existing balances.

Empirical data indicates that interest rates are, at best, marginally risk-based. The Federal Reserve tracks the average interest rates offered by commercial banks both on all credit card accounts and on accounts on which interest was charged. Accounts on which interest is charged are an inherently riskier subset of all credit card accounts.

²¹ 12 C.F.R. Pt. 226a5(b)(1); 12 C.F.R. Pt. 226, App. G-10(A)-(B).

If card interest rates were risk-based, then one would expect interest rates on accounts charged interest to be consistently higher than on cards in general. But as the Chart 3 shows, the interest rates on accounts charge interest have alternatively been higher and lower than card accounts in general. This flip-flopping indicates that, at least until 2004—fourteen years in the so-called risk-based pricing era—pricing was not risk-based. Only since 2004 has the expected for rate gap emerged, and it is quite small, in the nature of 1%.²² In other words, there is scant evidence that low-risk transactors are offered lower interest rates than higher-risk revolvers.

Chart 3. Terms of Credit Card Accounts at Commercial Banks



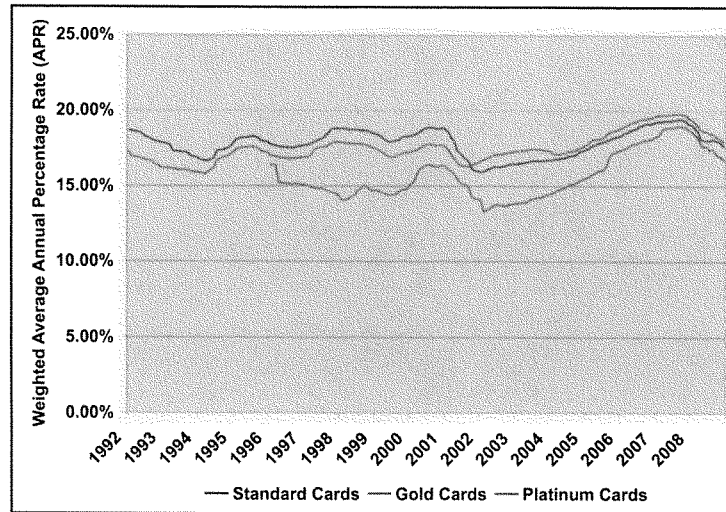
Source: Federal Reserve Statistical Release G.19.

Likewise, as Chart 4 shows, the spread in the effective interest rate charged between Platinum cards (issued to the most creditworthy cardholders), Gold cards (issued to less creditworthy cardholders), and standard cards (issued to even less creditworthy cardholders) is negligible. The effective rate charge includes penalty rates, but excludes promotional teasers. The difference in effective interest rates charged on Platinum Cards and Standard Cards, weighted for market share, was .91% in February 2008.²³ Even for base interests, arguably the most risk-sensitive and important component of credit card pricing, it is hard to discern anything more than a negligible risk-based pricing spread among high risk and low risk pools. Most of credit card price has nothing to do with risk.

²² Federal Reserve Statistical Release G.19.

²³ CardData, www.carddata.com (subscription data source).

Chart 4. Base Interest Rate APR by Card Type (Weighted by Market Share of Outstandings)



Source: CardData (subscription data source).

2. Late Fees and Overlimit Fees

Late fees and overlimit fees are also only marginally risk-based. Many issuers have up to three tiers of late fees, depending on the size of the late balance, but these tiers are much less exact at reflecting risk than if the fee were a simple percentage of late balance. Nor do late fees account for important risk factors like how late a payment is—the fee is the same whether it is received one hour or one month late. Nor are late fees based on the cardholder's individual risk profile. For example, Capital One, fourth largest card issuer in terms of total cards,²⁴ has the same late fee for consumers regardless of their credit profile.²⁵ Capital One's late fee is tiered based solely on the account balance at the time the fees are applied.²⁶

Likewise, overlimit fees bear no connection with the risk posed to the card issuer. Overlimit fees are typically flat fee amounts that do not vary by credit profile. A consumer who goes one penny over the limit pays the same amount as a consumer who goes \$200 over the limit. Some issuers vary overlimit fees by the amount of consumers' credit limits, which are a function of credit risk profiles, among other factors, but even then it is within a limited number of tiers.

For example, some of Capital One's cards do not have overlimit fees at all. For other cards, Capital One has three tiers of late fees, one for consumers with credit limits

²⁴ Nilson Report #896 (Feb. 2008), at 9.

²⁵ See Capital One Card Lab, at <http://www.capitalonecardlab.com/> (disclosure statements by credit profile on file with the author).

²⁶ *Id.*

under \$500, another for those with credit limits of at least \$500, but less than \$1,000, and a third for consumers with credit limits over \$1,000. A cursory perusal of consumer bankruptcy filings and claims shows that even consumers who are serious credit risks often end up with credit limits well over \$1,000.²⁷ Tiered overlimit fees based on credit limits are only vaguely risk-based, and when considered with the absence of overlimit fees on some cards, it is hard to see overlimit fees as being a risk-based pricing mechanism. If card issuers were truly concerned about the risk from overlimit transactions, they would either not permit overlimit transactions or make overlimit fees a percentage of the amount overlimit. Most issuers' overlimit fees are penalties, not risk-compensation.

The structure of late and overlimit fees makes it impossible for them to relate to individual consumer risk profiles. Similarly, other credit card price points, such as annual fees, merchant fees, transaction fees, and other back-end fees have no relation whatsoever to consumers' credit risk. To the extent that some credit card price points are risk-based, they are incredibly blunt instruments. Overall, credit card pricing is only marginally sensitive to consumer credit risk.

3. *Flawed Credit Scores Constrain Card Issuers' Ability to Price for Risk*

When one considers the data from which credit risk is assessed—consumer credit reports—it is apparent why the credit card industry has no real interest in implementing true risk-based pricing. Consumer credit reports are seriously flawed as data sources.

Credit reports contain only certain reported (not actual) debts and lines of credit. They are both over- and under-inclusive in their listing consumers' debts, often fail to include positive payment information, contain no information whatsoever on consumers' assets and income, and may not be updated to reflect changes in risk profile in a timely manner. 70% are riddled with errors, including false delinquencies and mismatched accounts.²⁸

There is no requirement that creditors file reports with credit reporting agencies,²⁹ so credit reporting may not show the full picture of a consumer's financial activity. This means credit reports can make consumers look either riskier or less risky than they actually are as borrowers. Moreover, most creditors are not required to file any particular information with reporting agencies when they do file.³⁰ Often they will file only negative information or omit key elements of data, such as credit limits.³¹ And some creditors are reluctant to file information about certain types of consumers, out of competition concerns.³²

It would be irresponsible for a card issuer to rely on such a flawed source for determining its prices. Indeed, both Citibank and JPMorgan Chase Bank have announced

²⁷ 2007 Riverside-San Bernardino Bankruptcy Project data (on file with the author).

²⁸ U.S. Public Interest Research Group, *Mistakes Do Happen: Credit Study Errors Mean Consumers Lose*, March 1998.

²⁹ Federal Trade Commission and Board of Governors of the Federal Reserve System, *Report to Congress on the Fair Credit Reporting Act Dispute Process*, August 2006, at 8.

³⁰ *Id.*

³¹ *Id.* at 9.

³² *Id.*

that they were ceasing to use credit bureau information to adjust credit card interest rates.³³ If two of the largest and most sophisticated card issuers in the country have determined that credit bureau information is a poor source of consumer risk data, we should be chary of other card issuers' reliance upon such data.

The credit card industry is not capable of doing individualized risk-based pricing. Instead, it prices consumers in pools based on certain general risk characteristics. Accordingly, there is inevitably cross-subsidization going on among consumers.

B. RISK-BASED PRICING DOES NOT EXPLAIN ABUSIVE BILLING PRACTICES

The total cost of credit card usage for cardholders is shaped not just by explicit price points, but also by covertly through billing practices. Even if the credit card industry were truly engaged in risk-based pricing, risk-based pricing does not explain abusive and exploitative billing practices, such as: residual interest, two-cycle billing; any-time, any-reason changes in terms; retroactive changes in interest rates; multiple applications of overlimit fees in a single billing-cycle; allocation of payments to the lowest interest rate debt; and universal cross-default. When one looks at the entirety of credit card pricing to consumers, not just the base interest rate, it is clear that card pricing is not risk-based overall. Instead, card pricing and billing structures are designed to exploit card issuers' market power in order to extract rents from locked-in and often unaware card users.

1. Residual or Trailing Interest

Card issuers apply finance charges to the average daily balance outstanding during a billing cycle. A new billing cycle starts, however, before the old billing cycle's bill has been sent out and payment has been received. If payment on the preceding cycle is received in full and on time, then it is not included in the average daily balance. But if even a penny of it is late or not paid, then the previous cycle's balance is treated as outstanding for the days that would otherwise be in the grace period.

To illustrate how residual interest works: if a cardholder charges \$5,000 in cycle 1 which ends on September 30, the cardholder does not get a bill until, say, October 7, after the start of the October billing cycle. The cardholder then pays \$4,500, which the issuer receives on October 12 (on time). Then on October 16, the cardholder charges another \$2,000. The cardholder's total daily balance for the October billing cycle (closing on October 31st), is calculated thus:

Oct. 1-Oct. 12 (12 days @ \$5000)=\$60,000

Oct. 13-Oct. 15 (3 days @ \$500)=\$1,500

Oct. 16-Oct. 31 (16 days @ \$2500)=\$40,000

³³ Press Release, Citigroup, *Citi Announces Industry Leading Changes to its Credit Card Practices*, March 1, 2007, at <http://www.citigroup.com/citigroup/press/2007/070301b.htm>; Press Release, Chase Card Services, *Chase Announces Clearer, Simpler Credit Card Pricing Approach: Chase Will No Longer Increase Rates Based on Credit-Bureau Information*, Nov. 19, 2007, at http://biz.yahoo.com/bw/071119/20071119006007.html?_v=1.

Total Daily Balance: \$101,500

This is then divided by the number of days in the cycle (31), yielding an average daily balance of \$3,274.20, to which the finance charge is applied. 14.49% compounded daily for 31 days on \$3,274.20 is \$41.10.

Not that the cardholder repaid \$4,500 back on time, but are still assessed interest on it. But for residual interest, the average daily balance would computed as:

Oct. 1-Oct. 15 (15 days @ \$500)=\$7,500
Oct. 16-Oct. 31 (16 days @ \$2,500) = \$40,000

Total Daily Balance: \$47,500

This would yield an average daily balance of \$1532.30, so interest would be applied to a balance that is 53% lower. At 14.49% APR interest, compounded daily, the finance charge, without residual interest would be \$19.24.

Residual interest thus cost this hypothetical cardholder \$21.86 (\$41.10 minus \$19.24) in a single month. Annualized, that is \$262.32 in residual interest—interest accrued on funds that were repaid on time. For a household making less than \$50,000 per year, this extra \$262.32 in interest represents 13% of their annual discretionary income. Even for wealthier households, earning \$50,000-\$99,999 per year, it is over 2% of discretionary income.

Cardholders should not be paying interest on funds that they have repaid on time. Eliminating residual interest would have the effect of significantly increasing American families' discretionary spending capacity and would foster real economic growth. Billing tricks and traps like residual interest drain away spending power from American consumers.³⁴

³⁴ The existence of residual interest means that if a revolving cardholder submits a payment for the entire balance indicated on the billing statement, there will still be a remaining residual interest balance to pay the next month. Residual interest can actually create a financial Zeno's paradox, in which the cardholder can never eliminate the balance, except by overpaying the issuer or closing the account.

To illustrate, suppose a cardholder had an interest rate of 10%, compounded daily, and a revolving balance of \$1000. The customer mails in a payment for \$1000, which is received by the issuer 25 days after the statement was generated. The cardholder would then receive a bill the next month for \$6.87, that is 25 days worth of interest. The cardholder then sends in \$6.87, say another 25 days later and thinks that the bill is paid off in full finally. But the next month, the cardholder receives a bill for \$1.00. Interest has accrued on the residual balance of \$6.85 for 25 days, which should be 5¢, but because the card issuer has a minimum finance charge of \$1.00, the cardholder is billed for \$1.00. At this point, assuming that there are no further charges made and no double-cycle billing, the cycle repeats itself again and again. The cardholder pays \$1.00, but and less than a penny of interest accrues, but the cardholder is charged \$1.00.

Theoretically this can go on forever; the only way the cardholder can pay off the balance is to overpay by a sufficient amount to cover the residual interest in a month or to close the account. Cardholders should not find themselves in the Groundhog's Day of residual interest and have to either overpay or close their account in order to eliminate all balances.

2. *Two-Cycle Billing*

Residual interest is closely related to two-cycle or double-cycle billing. Two-cycle billing calculates an average daily balance based on the current and past billing cycle.³⁵ To illustrate, in month one a cardholder charge \$500 and pays off \$450 off at the end of the month. In month two, the cardholder charges \$500 and pay off \$400. Interest accrues as if on a balance of \$600, even though the cardholder only owes \$150 (\$50 balance from month one plus \$100 balance from month two).

What both residual interest and two-cycle billing share is that they calculate the average daily balance to which the finance charge is applied by including amounts that have been timely repaid. And as with residual interest, the result is that the cardholder pays a far higher effective interest rate than is disclosed under Truth-in-Lending provisions. In this example, the cardholder would be paying an effective interest rate four times higher than that disclosed in the cardholder agreement. Two-cycle billing is neither risk-based nor even cost-based, as it computes interest based on balances that have already been paid off, where there is no risk whatsoever. Instead, two-cycle billing merely exploits card issuers' market power to squeeze more dollars out of unwitting cardholders.

3. *Unilateral Term Changes*

Many cardholder agreements permit the issuer to change the terms of the agreement, including the interest rate, unilaterally, at any time, for any reason. Applied purely prospectively, this is could be a risk-based provision that allows card issuers to adjust future pricing based on changed risk-profiles. In practice, however, these terms are often applied in ways that have no relation to changes in risk. For example, opening of a new low-limit charge account is often an act that can trigger an increase in interest rates, such as the application of a default interest rate that can easily be twice as large as the base rate. Surely, though, the cardholder's likelihood of default has not doubled merely by opening an additional line of credit. There is nothing that restricts unilateral any-time/any-reason terms to being risk-based repricing.

Even if unilateral any-time/any-reason terms were applied sensibly in relation to risk they are still problematic because of the significant lock-in effect for card users. I commend to the Committee a recent study by Professor Lawrence Ausubel that estimates the average cost of switching cards at \$150.³⁶ Not only does it take a week or so to get a new card, during which the consumer's cash management might be severely constricted, but switching cards hurts a consumer's credit rating, and affects not only the price at which the consumer can get further cards, but also the price at which the consumer can get any form of credit. Given the lock-in effect of credit card borrowing, unilateral any-time any-reason terms are more like rent-extraction devices than risk-based pricing terms.

³⁵ Double-cycle billing can be combined with residual interest, so that charges from a third billing cycle that are paid off during the grace period still are figured into the balance calculation.

³⁶ Haiyan Shui & Lawrence M. Ausubel, *Time Inconsistency in the Credit Card Market*, 14th Annual Utah Winter Finance Conference, at <http://ssrn.com/abstract=586622>. See also Paul S. Calem *et al.*, *Switching Costs and Adverse Selection in the Market for Credit Cards: New Evidence*, 30 J. BANKING & FIN. 1653 (2006) ("information based barriers to switching have remained relevant in the credit card market despite the many changes seen in the market over the past decade")

The card industry contends that risk-based repricing is necessary to negate the moral hazard that would exist if consumers did not incur costs for becoming riskier borrowers.³⁷ When someone does not bear the full costs of his actions, he is likely to engage in riskier behavior than he would otherwise. This situation is moral hazard. Moral hazard could exist in the credit card context because a person who knows that the cost of borrowing funds will not change if his credit risk increases may be less motivated to maintain good credit.³⁸

The moral hazard argument is flawed, however, because issuers often determine credit risk by factors that are out of the control of the individual, and that may well be inaccurate. A consumer simply cannot know whether opening up an additional line of credit will result in a higher interest rate or not under unilateral term change provisions. Likewise, a *bona fide* dispute with a landlord might be viewed as risky. The consumer cannot know whether pursuing her rights against the landlord, such as withholding rent, will result in higher interest rates on credit cards. Because of the lack of clarity of what constitutes risky behavior and the lack of consumer control over many risk factors, it is unlikely that risk-based repricing will effectively dissuade risky credit behavior.

If card issuers were truly concerned about moral hazard they would make the trigger events to term changes very clear and apply them scrupulously. They do not. Unilateral any-time/any-reason term changes are devices to squeeze additional payments out of cardholders rather than to deter moral hazard.

4. *Retroactive Application of Interest Rate Increases*

Many card issuers apply increases in interest rates retroactively to existing balances. Combined with two-cycle billing, this can even be applied retroactively to balances that have been paid off. This is not risk-based pricing. Risk-based pricing means that the pricing has to be fixed *before* the risk materializes. The whole idea of risk-based pricing is that it is supposed to be prospective risk-based pricing. Risk is a prospective concept; after-the-fact pricing is at the very least cost-based, and can easily be used to milk cardholders by pricing at a level far above cost. After-the-fact pricing is not risk-based.

The classic financial services example of risk-based pricing is insurance. Insurers offer premiums based on the individual risk-profile of the insured. An insurer cannot decide to change the premium required for past coverage after the coverage event occurs; there would be no risk-involved. It would be unconscionable for an insurer to base coverage for a past event on the payment of higher premiums, retroactively applied; the whole reason people purchase insurance is so they do not have to pay the full costs of the event they are insuring against.

Insurance is just lending upside down. Lenders and insurers both gamble on risk. The insurer is paid premiums up front and pays out *after* the risk materializes. The lender pays out up front, but receives its payments later *if the risk of default does not materialize*. The timing of payments and the risk contingency differs between lending

³⁷ ABA Study, *supra* note 17, at 12.

³⁸ *Id.*

and insurance, but the core economics is the same—a gamble on whether a risk materializes. Doing cost-based or cost-plus-rent-extraction-based pricing defeats the benefits of true risk-based pricing for consumers.

Retroactive application of interest rates means that instead of paying according to risk, which would limit moral hazard, cardholders who revolve pay whatever the issuer decides, regardless of their risk profile. Again, retroactive application of interest rates provides an example of card issuers' exploiting their market power over cardholders, not risk-based pricing.

5. *Universal Cross-Default*

Many cardholder agreements contain universal cross-default clauses that provide that the cardholder's account is default if the cardholder is declared in default (accurately or not and with notice or not) by any other creditor, even if the cardholder has been making payments on time to the card issuer. Cross-default clauses are common in the corporate lending world, although the default triggers are usually limited to defaults on bonds or other lines of credit, not any possible contract dispute.

Universal cross-default appears at first blush to be a risk-based pricing mechanism. But there is no obligation for issuers to verify the fact of a default. The typical source of issuers' knowledge of a default are credit reports, but credit report entries are made without consumers' knowledge and hence ability to contest. The Fair Credit Reporting Act³⁹ does not require any notification of the consumer of the entry of negative information in a credit report. Thus, as a measure of real risk, universal default is problematic.

6. *Multiple Applications of Overlimit Fees in One Billing Cycle*

Some card issuers will charge a cardholder an overlimit fee for every overlimit transaction in a single billing cycle. This practice is not risk-based because it has no relation to the total amount of overlimit spending. A single \$200 overlimit transaction will produce only one overlimit fee, whereas three \$20 overlimit transactions (or \$60 total overlimit) will produce five overlimit fees. This system can often result in pricing that is actually *inverse* to risk.

7. *Allocation of Payments to Lowest Interest Rate Balances*

If a cardholder has balances accruing interest at different rates, such as a purchase balance and a cash advance balance, many card issuers apply payments to the lowest interest rate balance. This is not risk-based pricing. The risk should be reflected in the interest rates, not in the payment allocation because the card issuer cannot know when lending how the balances will be paid—they could be paid off in full in one cycle, or it might take a while. This uncertainty does not relate to the cardholder's risk profile and cannot be accounted for in the payment allocation method. Any method other than pro rata is simply rent-extraction, not risk-based pricing.

³⁹ 15 U.S.C. § 1681 *et seq.*

8. *Accrual of Interest on Fees Within the Same Billing Cycle*

Some issuers apply overlimit fees on the date of the overlimit transaction, rather than at the end of the billing cycle. This means interest accrues on the overlimit fee for part of the billing cycle, which functionally increases the amount of the overlimit fee beyond what is disclosed; the cardholder pays not only the stated overlimit fee, but an overlimit fee that consists of the fee plus interest on it.

This practice is the quintessential “junk fee.” The cardholder has not borrowed the overlimit fee amount from the issuer; no cash has flowed out of the issuer’s pocket. There is only a notional credit given to the consumer in the form of the fee being levied. To apply interest to a junk fee, especially in the same billing period that the fee is levied, is an unfair windfall to the card issuer and jacks up the price of using a card beyond what the consumer can anticipate.

The total cost of credit card usage for cardholders is shaped not just by explicit price points, but by billing practices, many of which are not risk-based, but instead designed to exploit card issuers’ market power in order to extract additional payments from locked-in card users.

C. *The Ephemeral Benefits of “Risk-Based” Credit Card Pricing*

1. *“Risk-Based” Pricing Has Dubious Benefits for Creditworthy Consumers*

Even if the card industry’s pricing were meaningfully risk-based pricing, it is far from clear whether either creditworthy or subprime consumers benefit from it.

a. *Card Benefits Have Declined for Transactors*

There are two types of creditworthy cardholders. First, there are cardholders who never revolve a balance. They use credit cards merely to transact and enjoy the “float” during the interest-free grace period. Second, there are cardholders who revolve balances, but generally make at least the minimum payment on time.

Only a very small percentage of cardholders *never* revolve a balance. In 2007, 86% of cardholders revolved a balance at least once,⁴⁰ and over 60% consistently revolved a balance.⁴¹ If we were to look over a period of several years, those numbers would be much higher. There are very few pure transactors; instead, there is mainly a spectrum of revolvers.

For those handful of cardholders who never revolve balances, there are no direct costs of credit other than possibly annual fees. Annual fees are less common than they once were, but cardholders have never needed to pay annual fees, so for savvy transactors, there really has been no change in the direct cost of cards. What is relevant to transactors, however, is the length of the float or interest-free grace period before repayment.

Card issuers are required, by law, to have a 14-day interest-free repayment period.⁴² Traditionally, issuers permitted a significantly longer period, often 30-days. As

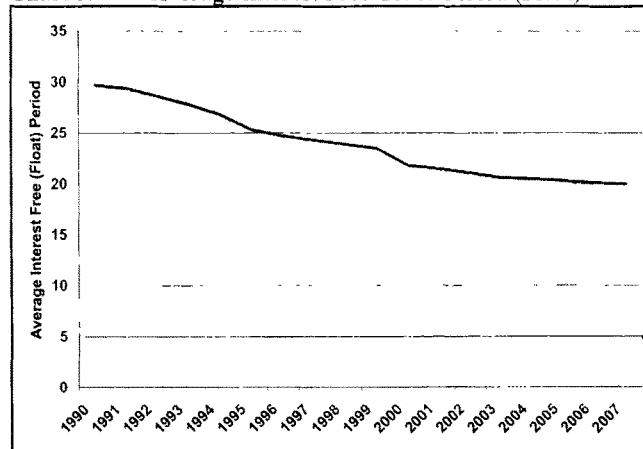
⁴⁰ Ireland, *supra* note 2.

⁴¹ CardData (subscription data source).

⁴² 12 C.F.R. Part 226.5(b)(ii).

Chart 5 shows, since the early 1990s the average float period has declined from around 30 days to 20 days. One-third of the major benefits of credit card usage to creditworthy non-revolving cardholders have disappeared since the onset of risk-based pricing. If pricing were truly risk-based, it is hard to understand why card issuers needed to cut their float exposure by a third. Rather than explicitly raising prices on creditworthy transactors, card issuers have done the economic equivalent by reducing the benefit given to them.

Chart 5. Average Interest Free Grace Period (Float)



Source: CardData (subscription data source).

Declining float also increases the potential likelihood that of a creditworthy consumer making a late payment and getting hit with late fees and penalty interest rates. And as soon as creditworthy consumers start paying interest and fees, their creditworthiness declines.

b. The Drop in Base Interest Rates Is Due to a Drop in Issuers' Cost of Funds

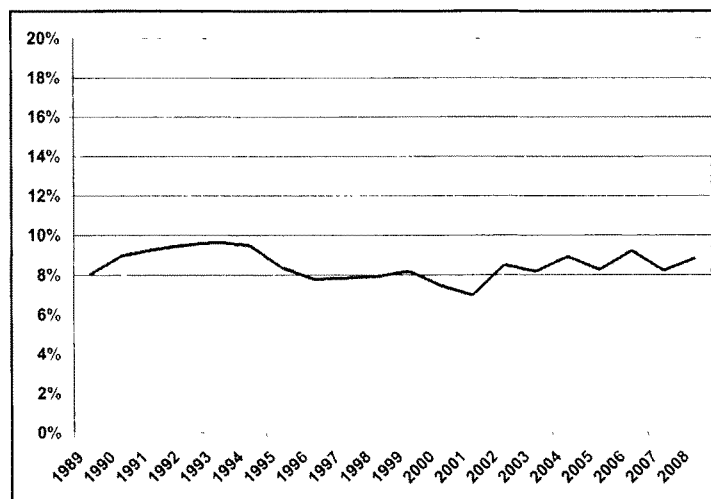
Creditworthy cardholders who revolve balances have supposedly benefited from risk-based pricing in the form of lower base interest rates. The decline in base interest rates, however, is attributable to a decline in card issuers' cost of funds and has been offset by higher backend fees. Because credit cards have multiple price points, one cannot gauge the cost of credit merely by looking at one price point. Credit card pricing is designed in such a way that it is near impossible to calculate the total cost of carrying balances on a card, but overall, it appears that the costs of revolving balances on credit cards might have gone up since the advent of risk-based pricing.

Since 1990, when risk-based pricing supposedly began, base interest rates on credit cards have dropped. There is some dispute over the amount of the drop, in part because of the inadequate nature of official credit card statistics.⁴³ Nevertheless, empirical data strongly indicates that the decline in base interest rates is largely

⁴³ See Levitin, *supra* note 1.

attributable to card issuers' lowered cost of funds.⁴⁴ The proof is that between 1990 and present, card issuers' net interest margin—the difference between the interest rate charged consumers and the cost of funds of card issuers—has remained static since before 1990, as shown below in Chart 6.⁴⁵ The multi-panel time series data showing static net interest margins proves that changes in base interest rates largely reflect changes in card issuers' cost of funds, not so-called “risk-based” pricing. Cost of funds, and not risk-based pricing explains virtually the entire decline in credit card interest rates since 1990.

Chart 6. Net Interest Margin of Credit Card Lenders



Source: FDIC Quarterly Banking Profiles, Net Interest Margin by Asset Concentration Group.

2. Three Credit Card Monte for Revolvers' Pricing

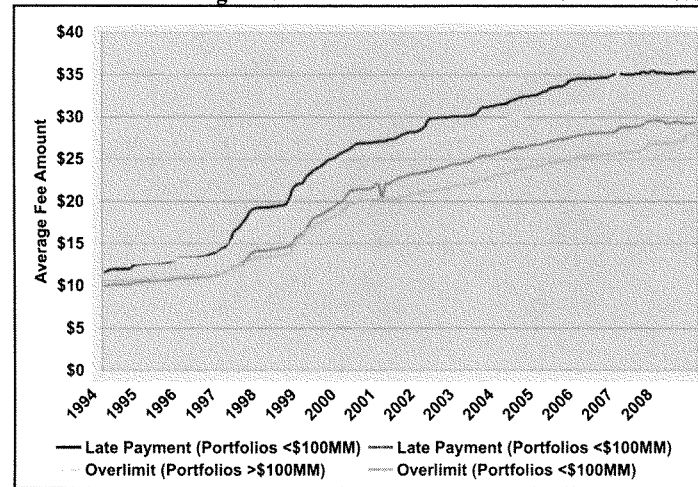
The decline in base interest rates since 1990 has been offset by increases in other credit card fees that do not distinguish between creditworthy and riskier cardholders, so there is no net benefit to creditworthy consumers. As Chart 7 shows, late fees and over-

⁴⁴ Board of Governors of the Federal Reserve System, *The Profitability of Credit Card Operations of Depository Institutions*, (Washington, D.C.: June 2005). This decline in the cost of funds may be due, in part, to the ability of credit card lenders to tap international securities markets for funds by securitizing card receivables. Board of Governors of the Federal Reserve System, 11-12. A 2006 GAO Report considered possible causes for the decline in interest rates, but was unable to pinpoint a cause. United States Government Accountability Office, *Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers*, Study to the Ranking Minority Member, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate (Sept. 2006), GAO-06-929, at 15, 17, 35-51 (*hereinafter*, "GAO"). The GAO Report mentioned, as possible factors, risk-based pricing, along with increased competition from the entry of monoline card issuers (Capital One and MBNA) to the market, greater consumer awareness of interest rates because of the implementation of the Schumer box, and a decline in the cost of funds.

⁴⁵ FDIC Quarterly Banking Profile, Net Interest Margin by Asset Concentration Group.

limit fees are up an average of 160% and 115%, respectively, from 1990 to 2005.⁴⁶ As Professor Ronald Mann has noted, the aggregate amount of late and overlimit fees “as a share of outstanding debt, has doubled since 1990, increasing from about 70 basis points per year in 1990 to 140 basis points per year in 2004.”⁴⁷ Additionally, credit cards now feature many charges and fees that did not exist in 1990, such as penalty interest rates, cash advance fees, balance transfer fees, telephone payment fees, stop payment fees, additional card fees, convenience check fees, money transfer fees, statement copy fees, and foreign transaction fees.⁴⁸ Moreover, minimum finance charges have increased, and the definition of certain transactions, such as cash advances have been broadened to apply to more transactions.⁴⁹

Chart 7. Average Fee Amount for Late Fees and Overlimit Fees



Source: CardData (subscription data source).

When one nets out lower base interest rates with increases in other fees, it becomes clear that creditworthy consumers who pay fees might actually be worse off. For example, on a \$500 balance, paid off over six months with 20% annual interest compounded daily and a \$10 late fee, the consumer would pay a total of \$562.85. By contrast, with 10% annual interest compounded daily and a \$45 late fee, the consumer would pay a total of \$572.54.

⁴⁶ United States Government Accountability Office, *Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers*, Study to the Ranking Minority Member, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate (Sept. 2006), GAO-06-929, at 18.

⁴⁷ Ronald J. Mann, *Bankruptcy Reform and the "Sweatbox" of Credit Card Debt*, 2007 U. ILL. L. REV. 375, 389 (2007).

⁴⁸ Mark Fulleit, *Credit Card Pricing Developments and Their Disclosure*, Discussion Paper, Payment Cards Center, Fed. Res. Bank of Phila., Jan. 2003, at 26.

⁴⁹ *Id.*

This shows that base interest rates are not a useful metric for measuring the actual cost of credit cards. A better metric is weighted average interest rates, including penalty rates. When penalty rates are included in weighted average interest rates, there is only a 0.41% spread between standard cards (for those who are just above subprime) and platinum cards (for the far more creditworthy).⁵⁰ On a \$500 balance, this spread would amount to a savings for the Platinum cardholder of \$2.05, less than the cost of a gallon of gasoline or a cup of coffee. There is good cause to think that many creditworthy cardholders may not have benefited from changes in card pricing and some may have even been harmed by the shift away from upfront interest rates and toward backend fees and penalty interest rates.

3. *Subprime Consumers Have Not Benefited from Risk-Based Pricing*

In recent years there has been a dramatic growth in the availability of credit, including credit cards, to subprime consumers. This growth has been fueled by securitization, rather than risk-based pricing. Securitization is a financing method in which card issuers bundle large numbers of cardholder receivables and selling them to specially created trusts. These trusts pay for the accounts receivable by selling securities, which are secured by and paid off from the receivables' revenue stream. The card issuer typically serves as the servicer for the accounts receivables in the trust in exchange for a fee.⁵¹

Securitization allows card issuers to obtain cash now for debts that will take a while to collect. It also allows them to transfer credit risk to the trust (and ultimately the investors in the trust).⁵² Securitization also lets card issuers increase their lending capacity. Federal and state banking regulations require the banks and thrifts that issue credit cards to maintain certain reserves of capital as a provision against loan losses. The more loans a financial institution has outstanding, the more capital it has to keep on hand in liquid form earning little return. Securitization enables card issuers to underwrite more debt without maintaining higher reserve requirements.

Reserve requirements only apply to the receivables a card issuer carries on its books; once the receivables are sold to a securitization trust, the reserve requirements do not apply, and the card issuer's capital is available for underwriting additional loans. Likewise, securitization of risky debt helps credit card lenders avoid the even higher reserve requirements caused by 180-day delinquent revolving debts.⁵³ Securitization allows card issuers to move debt (and especially delinquent debt) off their books and avoid "charge-offs" and thus maintain lower reserve levels. Thus, securitization has by

⁵⁰ CardData, Monthly Pricing Averages, U.S. Standard Card Weighted and Platinum Card Weighted. There is no standard definition of subprime, but a rule of thumb is that consumers with FICO scores beneath 600 are subprime, and above 650 are not. Definition varies by lender between 600 and 650. See Dana Dratch, *Buyer Beware on Subprime Loans*, BankRate.com, at <http://www.bankrate.com/bnm/news/debt/debtmanageguide/beware-subprime1.asp>. There is no data on average subprime card rates.

⁵¹ STEVEN L. SCHWARCZ *ET AL.*, SECURITIZATION, STRUCTURED FINANCE AND CAPITAL MARKETS 145 (2004).

⁵² *Id.*

⁵³ See 12 C.F.R. Pt. 3, App. C, Pt. 1 § 31(e) (national banks); 12 C.F.R. Pt. 567, App. C, Pt. 1 § 31(e) (federal savings associations); 12 C.F.R. Pt. 325, App. D, Pt. 1 § 31(e) (state member banks); 12 C.F.R. Pt. 208, App. F, Pt. 1 § 31(e) (insured state non-member banks).

itself dramatically increased banks lending capacity. Since banks can lend more, it is not surprising that they would be willing to extend more credit to more marginal consumers.

Securitization also shifts much of the repayment risk from the card issuer to the securitization trust.⁵⁴ This reduces the incentive for card issuers to have careful underwriting standards. Moreover, the master securitization trust structure (or more recently issuance trust structure) used for credit card securitization encourages lower underwriting standards. A master securitization trust continually acquires credit card receivables against which it issues securities.⁵⁵ This means that a master securitization trust will hold billions of dollars in credit card receivables, so that a higher initial default rate on any batch of millions of dollars of receivables it purchases from the issuer has little effect on the total return. Uncollected receivables reduce the excess spread that goes to the servicer-issuer, but it appears to be more profitable for issuers to screen out poor credit risk consumers *after* lending by looking at their payment history, than to screen them out *before* lending via underwriting diligence. Loans made to true deadbeats can be siphoned out by several months of seasoning more cheaply for the issuer than through careful upfront underwriting. Developments in the form of securitization have made it more profitable for some issuers to screen out the worst credit risks by payment history *after* issuing cards than by careful and diligent underwriting before issuing cards.

Securitization encourages card issuers to issue cards without regard to consumers' ability to repay because they do not bear the ultimate repayment risk from securitized accounts. Accordingly, card issuers are incentivized to lower underwriting standards and make credit cards available to subprime consumers who present serious credit risks. Indeed, the card solicitation and approval process appears to be so indiscriminate that as former Federal Reserve Board Chairman Alan Greenspan testified to this committee "Children, dogs, cats and moose are getting credit cards."⁵⁶ It is hard to reconcile credit cards issued to toddlers and pets with risk-based pricing.

⁵⁴ SCHWARCZ ET AL., *supra* note 51.

⁵⁵ FDIC CREDIT CARD SECURITIZATION MANUAL, at http://www.fdic.gov/regulations/examinations/credit_card_securitization/.

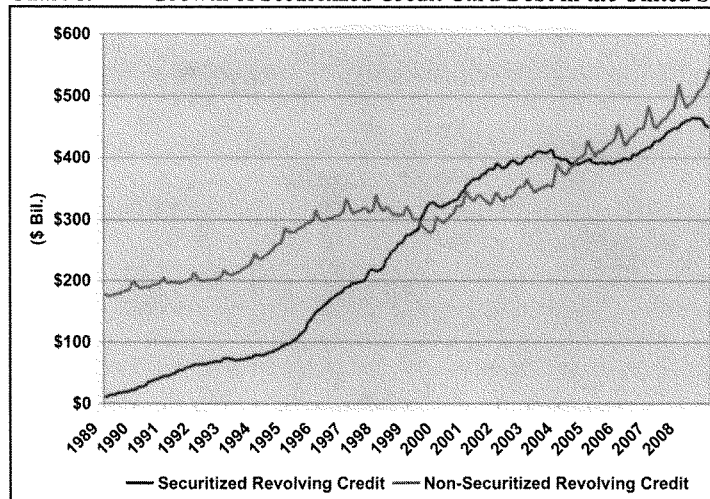
⁵⁶ *Credit Cards at 50: The Problem of Ubiquity*, N.Y. TIMES, Mar. 12, 2000, at C11. See also, e.g., *Dog Issued Credit Card*, NBC San Diego, Jan. 28, 2004, at <http://www.nbcsandiego.com/money/2800173/detail.html>; Jane Hughes, *Toddler Issued Platinum Card*, BBC News, Aug. 11, 1999, at <http://news.bbc.co.uk/2/1/americas/417131.stm>.

Section 1229 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 directed the Federal Reserve to "conduct a study of (1) consumer credit industry practices of soliciting and extending credit—(A) indiscriminately; (B) without taking steps to ensure that consumers are capable of repaying the resulting debt; and (C) in a manner that encourages consumers to accumulate additional debt; and (2) the effects of such practices on consumer debt and insolvency." In 2006, the Federal Reserve published the required study. The study concluded that "as a matter of industry practice, market discipline, and banking supervision and enforcement, credit card issuers do not solicit customers or extend credit to them indiscriminately or without assessing their ability to repay." Board of Governors of the Federal Reserve System, *Report to the Congress on Practices of the Consumer Credit Industry in Soliciting and Extending Credit and their Effects on Consumer Debt and Insolvency* (June 2006), 5.

Unfortunately, the Federal Reserve's conclusion is based solely on two short paragraphs of analysis that contain neither citations nor statistics, *id.* at 22, and fly contrary to common sense and the statement of Chairman Greenspan. There is no evidence that card solicitation and extension of credit is in fact based on consumers' ability to repay.

Securitization of credit card receivables was introduced in 1987⁵⁷ and has soared since 1989, when the Federal Reserve began compiling data on it, as shown by Chart 8. As Chart 8 shows, in recent years the volume of outstanding securitized revolving debt has matched or exceeded that of non-securitized revolving debt.⁵⁸ Around 60% of all credit card debt is currently held in securitized pools.⁵⁹ Chart 8 does not prove a causal relationship between securitization growth and lowered standards for access to credit, but it provides at least as compelling an explanation of increased access to credit for subprime consumers as does non-existent “risk-based” pricing.

Chart 8. Growth of Securitized Credit Card Debt in the United States



Source: Federal Reserve Bank Statistical Release G.19.

3. *The Dubious Benefits of Predatory Credit to Consumers: Fee Harvester Cards*

It is also far from clear whether subprime consumers really end up better off from access to credit cards. Access to credit is valuable only if one has the ability to repay. Otherwise, it is a Trojan horse. It is worthwhile considering the terms found on so-called subprime “fee harvester” cards.⁶⁰ These cards have credit limits of \$200-\$300, but they come with substantial upfront fees when the consumer opens the card account. These fees are charged to the card and thus potentially accrue interest and late fees. The upfront fees also reduce the cardholders’ initial available credit to a mere \$50-\$100. The

⁵⁷ Mark Furletti, *An Overview of Credit Card Asset-Backed Securities*, Discussion Paper, Fed. Res. Bank of Phila., Dec. 2002, at 1.

⁵⁸ Revolving debt is largely, but not entirely credit card debt, but securitized revolving debt is almost entirely credit card debt. See note 4, *supra*.

⁵⁹ Darryl E. Getter, *The Credit Card Market: Recent Trends, Funding Cost Issues, and Repricing Practices*, Congressional Research Service CRS 4-5 (Feb. 27, 2008).

⁶⁰ See National Consumer Law Center, *Fee-Harvesters: Low-Credit High-Cost Cards Bleed Consumers*, Nov. 2007.

effective APRs on these subprime cards are often in the range of 300%-500%, rates that approach or exceed the cost of a payday loan.⁶¹

For example, the First Bank of Delaware's Continental Finance Classic MasterCard comes with a \$300 credit limit.⁶² But there is a \$99 Account Set-Up Fee, an \$89 Participation Fee, a \$49 Annual Fee, and a \$10 monthly Account Maintenance Fee.⁶³ The initial total useable credit on the card is \$53, and the opening balance is \$247, with a 19.92% APR, compounded daily. In other words, the cardholder has incurred \$247 dollars in debt simply for the opportunity to borrow an additional \$53 at 19.92%. Assuming there are no overlimit fees, the effective APR is for this \$53 of available credit is 819%!⁶⁴

The terms of subprime cards speak for themselves; it is hard to imagine that anyone is better off borrowing at an 819% APR. Subprime lending invites predatory lending practices because of the presumed lower financial sophistication of subprime consumers. To the extent that anyone bothers to listen to what subprime consumers themselves say, it turns out that many don't think much of gaining access to credit cards. Sociological studies show that if the marginal subprime consumers did not have access to credit cards they would either borrow from friends and family or not borrow at all rather than turn to less desirable forms of credit (such as loan sharks).⁶⁵

The recent housing bubble burst shows how many households can be hurt when they are lured into lending arrangements that they cannot reasonably finance. It also shows how there are collateral costs ("externalities") to the entire financial system. Increased access to credit for subprime households beyond reasonable ability to repay is of dubious benefit to subprime consumers themselves and to society as a whole.

IV. CONCLUSION

"Risk-based" pricing's "benefits" are not a reason for Congress to shrink from regulating the credit card industry's abusive pricing and billing practices. If anything, the pool-based nature of credit card underwriting urges a regulatory regime similar to that for insurance—an on-going system of licensing and regulatory supervision, as well as standardized contracts, prohibitions on certain terms and requirements of certain other terms, and restrictions on types of fees.

Transparent pricing is a prerequisite for an efficient, competitive market and responsible consumer behavior. If the card industry were required to price its products in a straightforward manner, and it were less costly for consumers to switch cards, deceptive

⁶¹ *National Consumer Law Center*, *supra* note 60, at 20.

⁶² First Bank of Delaware, Continental Finance Terms & Conditions, <https://www.cfcapply.com/goldlmc/fbd-terms.htm> (last viewed November 28, 2007).

⁶³ *Id.*

⁶⁴ This figure was arrived at by compounding daily 19.92% interest on an initial balance of \$300 over the course of 365 days, broken down into a regular calendar year with a \$10 monthly service fee added to the compounding balance on the first day of each month. Over the course of a 365-day year, the initial \$300 balance plus monthly service fees will accumulate to \$486.96. In other words, the consumer will have paid \$433.96 in interest and fees in order to borrow \$53.

⁶⁵ Angela K. Littwin, "Comparing Credit Cards: An Empirical Examination of Borrowing Preferences Among Low-Income Consumers," available at <http://ssrn.com/abstract=101446>.

practices would be harder to maintain, Truth-in-Lending disclosures would be more effective, as consumers would be able to easily compare cards and make informed decisions about card usage, and competitive pressures would push down total card prices, forcing the card industry to operate more efficiently, benefiting all consumers.

I strongly urge Congress to pass legislation that creates transparency in credit card pricing and that creates an on-going regulatory system that is capable of quickly evaluating and responding to innovations in the consumer financial products market place.

February 12, 2009

Testimony of

Kenneth J. Clayton

On Behalf of the

AMERICAN BANKERS ASSOCIATION

Before the

Committee on Banking, Housing and Urban Affairs

United States Senate



February 12, 2009

Testimony of
Kenneth J. Clayton
on behalf of the
American Bankers Association
before the
Committee on Banking, Housing and Urban Affairs
United States Senate

Chairman Dodd, ranking member Shelby, and members of the Committee, my name is Kenneth J. Clayton, senior vice president and general counsel of the American Bankers Association (ABA) Card Policy Council, the group within the ABA that deals with card issues. The American Bankers Association brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than \$125 million in assets – represent over 95 percent of the industry's \$13.6 trillion in assets and employ over 2 million men and women.

I appreciate the opportunity to testify today on the new federal regulations for credit cards and proposed legislative changes. Today, credit cards are responsible for more than \$2.5 trillion in transactions a year and are accepted at more than 24 million locations in more than 200 countries and territories. It is mind-boggling to consider the computer network, communications system, billing and processing facilities, fraud protection programs, and customer service requirements needed to handle up to 10,000 payment card transactions *every second* around the world. It is an enormous, complicated and expensive structure – all dedicated to delivering the efficient, safe and easy payment vehicle we've all come to enjoy.

Credit cards are so easy and convenient to use that people often take them for granted. But make no mistake – these are loans, just like loans to buy a car or a home, or to pay for a child's education. Credit cards are incredibly flexible, leaving it generally to the borrower to determine when to borrow the money, in what amount, and how quickly to pay it back. Lenders who make these loans face significant operational, risk management, and funding challenges in making this product readily available to millions of Americans every day. Credit card issuers have developed sophisticated systems for seamlessly handling the enormous dollar volumes that flow through our economic system.

The ubiquity of credit cards has not always been the case. As recently as thirty years ago, some 38 percent of American families had credit cards. Today, that percentage has nearly doubled. This is a testament to how valuable this important payment instrument has become for meeting the daily needs of most Americans. It also demonstrates how integral credit cards are to our economy, both as a payments vehicle and source of credit. Today's credit card marketplace provides a dizzying array of options and choices for consumers. It is clear, however, that as the marketplace has evolved to provide greater benefits and broader access, it has also become more complex. As a result, the adequacy of disclosure and other regulation in this new marketplace has been called into question, and we recognize the legitimacy of concerns policymakers have raised over the last several years.

In response to concerns, the Federal Reserve Board, Office of Thrift Supervision and National Credit Union Administration released (on December 18, 2008) comprehensive revisions to the regulation of credit cards, fundamentally changing the protections offered consumers while forcing a complete reworking of the credit card industry's internal operations, pricing models and

funding mechanisms. These new rules (referred to here as the Federal Reserve's rule¹) carry the full weight of the law, and failure to comply with them subjects the issuer to potentially significant fines – potentially up to \$1 million per day for non-compliance – and enforcement actions. The extensive protections provided to consumers under the new rules were based on four years of intensive work that included consumer testing, review of thousands of public comment letters, and input from important policymakers, including Chairman Dodd and other members of this Committee. The changes are so broad they will affect every aspect of the credit card business.

As Federal Reserve Chairman, Ben Bernanke, stated, these rules represent “[t]he most comprehensive and sweeping reforms ever adopted by the Board for credit card accounts.” As a consequence, all credit card issuers are currently undertaking a massive overhaul of their business practices.

We understand that a difference of opinion still may exist on credit card practices. However, we would urge that any discussion over further legislation in this area be viewed in the context of the recent Federal Reserve rule, recognizing its sweeping nature, protection to consumers, impact on operations, and most importantly, its potential impact on the broader economy and the provision of credit to consumers and small businesses. It is our belief that this impact will be broad and not uniformly positive, potentially leading to reduced access to credit for millions of Americans and small businesses at the very time when they need access to credit for their daily expenses.

The regulators acknowledged the possible negative effects that this complete reworking of the credit card business will have on the provision of credit to consumers and others. To minimize the negative impacts, the Federal Reserve provided for an 18-month time period for

¹ We use this term for ease of reference throughout this statement, but it is intended to include the rules issued and authority to make changes by the Office of Thrift Supervision (for savings associations) and the National Credit Union Administration (for credit unions).

implementation. While we understand that some policymakers may view this implementation period to be too long, we urge a full exploration of the potential unintended negative consequences that may occur if a shorter timeframe is mandated. In fact, the regulators specifically noted that any shortening of this implementation period could cause “more harm to consumers than benefit.”²

The Federal Reserve’s actions addressed the past evolution of the credit card market and, just as importantly, put in place a regulatory framework to address the future evolution of this market. In fact, the Federal Reserve’s rule provides the necessary authority and flexibility for regulators to take action regarding practices that may be deemed unfair or deceptive in the future, whatever form they may take. It is inevitable that cardholder preferences will change, new payment system technologies will be developed, and competitors will offer new products and choices. We believe that the Federal Reserve is well positioned to oversee and make the necessary adjustments appropriate to this dynamic market.

ABA, on behalf of our membership (which includes all the major credit card issuers), pledges to work with this committee, bank regulators, and other interested parties to address any concerns that may remain.

In my statement, I would like to focus on three points:

- The Federal Reserve Regulations Constitute Sweeping Reform of Credit Card Practices and Have Addressed the Core Concerns of Cardholders.
- The Changes Already Made Will Have a Significant Impact on Card Issuers and the Economy.

² 74 Federal Register 5548

- The Federal Reserve Rule Should Be Allowed to Work and Provides a Framework for Future Changes.

I will address each of these points in turn. Following these, I will also provide some initial thoughts on the “Credit Card Accountability, Responsibility and Disclosure Act,” as you requested, Mr. Chairman, in your letter of invitation.

I. The Federal Reserve Regulations Constitute Sweeping Reform of Credit Card Practices and Have Addressed the Core Concerns of Cardholders

The evolution and increasing complexity of credit cards has raised some concerns about the ability of cardholders to understand the terms and conditions of their cards. While there certainly has been disagreement over how to address these issues, the ABA firmly believes it is in the best interests of all parties that cardholders fully understand the obligations they assume, the interest rate and fees they should expect, and how the management (or, in some cases, mismanagement) of credit card debt can affect their terms and access to other types of credit. The changes in rules announced by the Federal Reserve are significant and will affect every aspect of credit card lending. Among other things, the changes should provide a better understanding of the terms and conditions, and allow consumers to compare different cards and understand what they are paying for credit. These changes should be allowed to work.

While the focus, understandably, has been on the areas of disagreement about card practices, it must be said at the outset how critically important credit cards are for customers as a convenient, safe, and secure payment vehicle and the vital role that credit cards play in our economy.

We believe that the Federal Reserve’s rule – which represents the most sweeping reforms in the history of credit cards – has addressed the fundamental concerns of cardholders. These were

many of the same concerns expressed by many members of this committee and, indeed, the changes made mirror many provisions in proposed legislation. During that process, the Federal Reserve (and OTS and NCUA) attempted to balance additional consumer protections with the impact that restrictions may have on safe and sound lending and the broader economy.

The rule makes significant changes in three broad categories.

- The rule effectively eliminates many card practices, including “double-cycle billing” and repricing of existing balances (including “universal default”);
- The rule enhances consumer protections, by giving consumers more time to pay bills and limiting up-front fees for cards; and
- The rule simplifies communications to help consumers make better credit decisions.

Specifically, the rule takes the following aggressive actions:

Practice Eliminated: Interest Rate Increases on Existing Balances. Interest rate increases will not be allowed on existing balances, except for promotional rate cards where rate increases are disclosed at account opening, variable rate cards based on a public index, accounts that are 30 days late, or where consumers fail to comply with workout agreements. Issuers have re-priced existing balances, for example, based on some borrowers’ actions that suggest they present a higher risk of non-payment and due to increased funding costs. In essence, the regulators have prohibited these re-pricing practices except in certain limited circumstances, and have directly addressed broad-based criticisms over increased interest rates on existing balances. A similar provision was included in Sec. 108 of the “Credit Card Accountability, Responsibility, and Disclosure Act of 2008” (the CARD Act).³

³ S. 3252, as introduced in the 110th Congress

Practice Eliminated: Interest Rate Increases on Certain Future Balances. Interest rates may not increase on balances from transaction made within the first year, except in the circumstances listed above for interest rate increases on existing balances. In addition, consumers will have 45 days prior notice regarding rate changes before an increase in rates can take effect, giving consumers more than enough time to avoid such increases if they occur down the road. This provision of the final rule actually goes beyond proposed versions of the regulation and many versions of proposed legislation, and essentially locks-in interest rates going forward for the one-year period following the opening of an account.

Practice Eliminated: Double-cycle billing. The Federal Reserve eliminated the practice of charging interest on balances from the previous billing cycle due to the loss of an interest-free period. When a customer with no revolving balance makes a purchase, the issuer makes near-immediate payment to the merchant; however, the customer is billed in the next statement, often weeks after the purchase. The customer then decides whether to pay for the purchase or carry it as a revolving debt. Customers who pay the balance in full essentially get an interest-free loan for the period between the purchase and when they pay the issuer. However, in cases where a customer who paid in full the previous month, and then the following month chooses to revolve part of the balance, some issuers then charged interest from the date of purchase – essentially charging interest from the day the loan was taken. In other words, the customer forfeited the interest-free period. This is referred to as “double-cycle billing” because this interest charged is derived from transactions made in a prior billing period. The Federal Reserve has eliminated this practice. This is similar to provisions in Sec. 103 of the CARD Act.

Practice Eliminated: Payment Allocation Methods that Pay Off Low Rate Balances First. Card issuers will no longer be allowed to apply payments to the lowest interest-rate balances first.

Under the rule, payments in excess of the minimum payment must either go to higher interest rate balances first, or *pro rata* based on the balances at different interest rates. Issuers often use low, promotional interest rates to encourage prospective cardholders to transfer balances to their new card – often to the cardholders’ significant benefit. Some issuers are able to offer low initial interest rates to prospective cardholders because they are able to allocate payments on the account to these lower rates first. The rule prohibits this practice. A similar provision was included in Sec. 106 of the CARD Act.

Enhanced Customer Protection: Extended Time to Pay. Cardholders will be given additional time to pay. Statements must be sent at least 21 days prior to the due date, giving customers more time to pay and avoid consequences such as late payment fees. Sec. 107 of the CARD Act includes this requirement.

Enhanced Customer Protection: Limited Up-Front Fees. Up-front fees on subprime cards have been criticized as, among other things, misleading the borrower by reducing advertised credit limits through the application of high up-front fees. The final rule caps the amount of any up-front fees and requires that fees over a certain amount be amortized over six months, thus protecting these borrowers.

Enhanced Customer Protection: 45 Days Advanced Notice Before Higher Rates Apply. As noted, the rule prohibits the changing of interest rates for existing balances except under very limited circumstances, and even limits rate increases on *future* balances during the first year of the card. In addition, once card issuers are allowed to change interest rates for future charges (i.e., after the first year), the rule requires that cardholders must be given a 45-day advance notice of any

changes, giving them more than adequate time to take action. Similar language was included in Sec. 101 of the CARD Act.

Simplified Communications: Helping Customers Make Better Credit Decisions.

Perhaps the most important changes in the new rules are significant enhancements to credit card applications, account agreements, monthly statements, change in terms notices, and other communication materials. The changes are based on actual consumer testing, demonstrating one of the key advantages of allowing regulators to consider and change regulations as appropriate to changing consumer needs. Major changes will be made to ensure that consumers have information they want, in a manner they will understand, and in a format they will notice. These changes, along with format and terminology requirements, will ensure that consumers understand credit card terms and know what they are paying for credit based on their own use.

Applications will contain a significantly revised summary box that clearly explains the most important terms and conditions of the credit card in a manner consumers will understand. This will help them select an appropriate card. That same format and terminology will now be carried over and required on the account agreement that comes with the credit card. Thus, important terms will be highlighted in a special, noticeable and understandable box format that arrives with the card. This will make it easier for consumers to understand the terms once the card arrives and also provide a useful reference for consumers to consult later on.

February 12, 2009

The regulation also imposes comprehensive new requirements for periodic statements that will ensure consumers understand what they are paying for credit and how to avoid additional costs. For example, warnings about late payments and minimum payments will be listed and explained on monthly bills right where the payment information is presented. (See chart at the right for an example.)

In addition, totals of interest and fees, for the period and year-to-date must be provided on each periodic statement. Changes in terms will be clearly highlighted, as demonstrated in the example below.

Payment Information

New Balance	\$1,784.53
Minimum Payment Due	\$48.00
Payment Due Date	4/20/12

Late Payment Warning: If we do not receive your minimum payment by the date listed above, you may have to pay a \$35 late fee and your APRs may be increased up to the Penalty APR of 28.99%.

Minimum Payment Warning: If you make only the minimum payment each period, you will pay more in interest and it will take you longer to pay off your balance. For example, if you had a balance of \$1,000 at an interest rate of 17% and always paid only the minimum required, it would take over 7 years to repay this balance. For an estimate of the time it would take to repay your actual balance making only minimum payments, call 1-800-XXX-XXXX.

Please send billing inquiries and correspondence to:
 ☐ Box XXXX, Anytown, Anystate XXXXX

Important Changes to Your Account Terms

The following is a summary of changes that are being made to your account terms. You have the right to opt out of these changes. For more detailed information, please refer to the booklet enclosed with this statement.

These changes will impact your account as follows:

Transactions made on or after 4/2/12: As of 5/10/12, any changes to APRs described below will apply to these transactions.

Transactions made before 4/2/12: Current APRs will continue to apply to these transactions.

If you are already being charged a higher Penalty APR for purchases, in this case, any changes to APRs described below will not go into effect at this time. These changes will go into effect when the Penalty APR no longer applies to your account.

Revised Terms, as of 5/10/12

APR for Purchases	16.99%
Late Payment Fee	\$32 if your balance is less than or equal to \$1,000. \$39 if your balance is more than \$1,000

II. The Changes Already Made Will have a Significant Impact on Card Issuers and the Economy

These changes will provide benefits for many cardholders. However, these changes will have other economic impacts as well. This is because the new rule will affect every aspect of the credit card business, from how cards are funded, to how they are priced, to how they are marketed, and to how credit is allocated among customers of differing credit histories and risk. Because the rules are so strong, card lenders may have to increase interest rates in general, lower credit lines, assess more annual fees, and reduce credit options for some customers. The full impact of these changes will likely not be fully known for several years as business practices are changed and as the credit availability works its way through the economy.

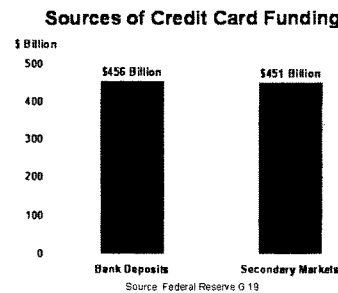
Impact of the new rules on credit availability: Restrictions on re-pricing higher risk accounts means two things: (1) that higher risk customers will likely see less credit available to them; and (2) since the higher-risk customers do not bear the full cost of the risks they pose, lower-risk customers will bear some of added cost. The Federal Reserve acknowledged this impact, as its Vice Chairman Donald Kohn stated: “There will be some reduction in available credit to some people.” Other experts did as well, as Scott Valenin of Friedman, Billings, Ramsey noted: “Because the new regulatory system eliminates preventive pricing..., rates across the board will go up, and availability of credit will go down.”

The impact on credit availability can be large. For example, Oppenheimer analyst Meredith Whitney estimated that card lines could decline by 45 percent (about \$2 trillion) because of economic and regulatory landscape. A study by Morrison & Foerster that covered 70 percent of card balances found that credit lines could be reduced by \$931 billion (an average of \$2,029 per account) and tightening lending standards could put credit cards out of reach for as many as 45

million consumers. It is likely that consumers perceived to have higher levels of risk – including those that are new to credit – will bear the brunt of these reductions. Thus, the inability to price risk effectively may well mean less access to credit for very deserving individuals just because card issuers are unsure of the credit risk involved and will not be able to price for that risk as it becomes more apparent. This means that many very creditworthy borrowers who do not have perfect credit histories or who have had limited experience with credit (and, therefore, have less credit history to guide issuers of their true risk of default) may not have access to credit.

It may also lead to higher interest rates or fees (such as annual fees) for all cardholders in order to compensate for the inability to price risk effectively. Thus, the least risky borrowers must now bear the cost for higher risk borrowers because the higher-risk borrowers may no longer bear the full cost of the exposure they pose to lenders. It may also be the case that payment allocation requirements will lead to the elimination of low-rate balance transfers that consumers and small businesses previously used to lower overall debt costs. Simply put, the sum total of all these rules will likely lead to reduced access to credit and higher prices to all consumers.

Impact of the new rules on funding: Credit cards are funded from two primary sources: deposits and secondary market funding, each accounting for about half – or \$0.5 trillion dollars – of the total funding of card loans to consumers (see chart at right). Funding in the secondary market relies on investors willing to hold securities that are backed by credit card receivables. *Any change* in the terms of issuance can greatly impact the receptivity of investors to holding these securities. If investors perceive that there is



greater risk, they are less likely to hold these securities, or may require significantly higher interest rates to compensate them for the risk. This means that less funding will be available, and if available, more costly. This translates into less credit available at higher cost to customers.

Investors are extremely sensitive to changes in the terms and conditions of the underlying asset. For example, the new rule restricts the ability of issuers to quickly re-price risk for borrowers who have, for example, missed payments or whose level of borrowings has risen to high levels. Investors may well be concerned about the performance of the credit cards backing their securities and shy away from holding them. ***The integral part that investors play in helping fund consumer loans – and the broader economy – cannot be understated.*** In fact, both the Treasury and the Federal Reserve have recognized the severe problems that exist in the funding area, and have proposed the Term Asset-Backed Securities Lending Facility (TALF) as a means of unlocking investor concerns. Shortening the implementation time frame, for example, may well act in direct conflict with the efforts under TALF.

Impact on risk-based pricing models: The requirements will force all credit card issuers to completely overhaul their pricing models to ensure that the risk for any cardholder is appropriately set to satisfy both regulatory concerns over safety and soundness and investor demands for strict underwriting and investment yield. Adequate time needs to be provided to ensure that the pricing is appropriately calibrated to the risk assumed so that the issuers are compensated for the risks they assume and investors are confident that securities backed by card loans will perform as expected. All of this affects the ability of issuers to make loans to consumers.

Impact on systems and operations: Overarching all of the key business decisions that must be made under the new rule (funding, pricing, credit availability, and marketing) are operational changes that must be made to business practices, software/programming, product design, periodic statements, advertisements, contracts, testing/auditing for compliance, customer service, training,

printing of new forms, training of customer service personnel, just to mention a few. For example, training for customer service personnel and modifications of call scripts could require hundreds of thousands of hours for each of the largest card issuers. The huge technological infrastructure that underpins the entire card system – including billing and account receivables – will demand hundreds of thousands of more hours for each issuer to comply. Periodic statements must be completely revamped, involving programming changes, testing, legal analysis to ensure compliance, focus group testing, and modifications of services from outside vendors. These changes are likely to take an additional hundreds of thousands of hours for large issuers.

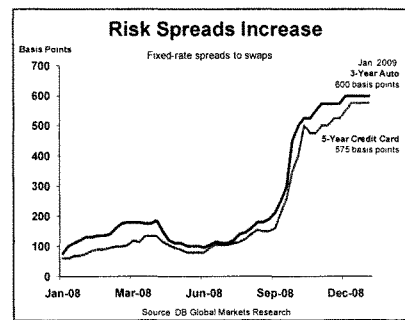
Beyond the business decisions and technical changes that must be made, every issuer must make sure that they are in full compliance with the changes. The penalties can be severe for non-compliance. Thus, legal and compliance review are critical, time-consuming, and expensive. The sweeping nature of the rules (which cover all aspects of card practices) and the new disclosures required (which cover all the printed – and electronic – materials, advertising, applications, solicitations, and credit card contracts) means that this undertaking is enormous.

Given the breadth of the changes anticipated, the Federal Reserve rule provided for an 18-month implementation period, with the expectation that card issuers will need all of it. When the rule was published in the *Federal Register* in December 2008, the regulators emphasized that: “If institutions were not provided a reasonable time to make changes to their operations and systems to comply with the final rule, they would either incur excessively large expenses, which would be passed on to consumers, or cease engaging in the regulated activity altogether, to the detriment of consumers.”⁴ In other words, consumers may immediately see much higher costs, and lenders may significantly cut back on lending even more than the regulations already will cause.

⁴ 74 Federal Register 5548

February 12, 2009

The 18-month implementation period is particularly important given the current economic recession, which is expected to last well into this year. There has already been a huge strain placed on the economy as credit from secondary markets – for mortgages, credit cards and auto loans – has largely disappeared due to the large risk-premium now demanded by investors (see the chart at right for autos and credit cards). While the 18-month implementation period may help ease the impact of the new rules, any additional restrictions that limit the ability of issuers to



effectively price according to risk, and any shortening of the time period to adopt the new rules, will send further chills in a market already in deep freeze.

We recognize that some observers believe this implementation period is too long. Certainly, we expect that some issuers may be in compliance, at least in part, before the end of the 18-month period, perhaps because they did not engage in or had already changed some practices or because they wish to compete on the basis of early compliance. However, because of the massive changes to pricing models, funding options and internal operations precipitated by the rule, overall compliance is going to take time. As Sandra Braunstein, the Director of Consumer and Community Affairs for the Federal Reserve noted that “18 months is a challenge in and of itself.” She stressed that “[i]n order to implement this, card issuers are going to need to rethink their entire business models...reprogram all their systems...redesign all the pieces of paper that they use...there needs to be adequate time allotted for that.” And, as there are 6,000 credit card issuers, it is unreasonable to assume that all could easily or simply change to be in compliance.

In fact, if the time period were shortened (particularly to as short as a few months as some have suggested), the impact could be devastating. There would not be time to evaluate the consequences for funding, pricing and allocation of credit. As a result, many issuers may not be willing or able to take the risk and would price and allocate credit accordingly. The Federal Reserve, which studied this in detail over the last several years, understood the enormity of the task and the implications for a shorter period.

III. The Federal Reserve Rule Should Be Allowed to Work and Provides a Framework for Future Changes

As I have described in detail above, the changes made in federal law affect every aspect of credit card lending. They will take a huge amount of bank resources to ensure that the new measures are fully implemented and effective. As the Federal Reserve recognized, the constraints on risk-based re-pricing and other limitations restricting the ability of issuers to act quickly in response to higher levels of default risk by borrowers will necessarily translate into less credit and/or higher-priced credit for some borrowers. The 18-month time period for implementation has the benefit of easing whatever adjustments might be made and the negative impact they may have on consumers. Time will be required to see how these new regulations will impact individual customers, small businesses and the broader economy. Before further regulating, it is important to gauge the full impact on the marketplace. Simply put, these new rules should be allowed to work.

The adjustments expected would need time even under the best of economic circumstances. Unfortunately, the economic recession adds additional concerns; changes in rules and business practices – and their implications for credit availability and pricing – will certainly be magnified in this recession. Secondary market funding is already in disarray; unemployment is rising; and delinquencies on credit cards are increasing. While credit card underwriting has been consistent and

did not follow the housing markets' foray into non-traditional affordability products, losses are increasing as individuals struggle to make ends meet. In fact, disruption in income – particularly from job losses – is by far the most significant predictor of delinquencies and losses on consumer loans. Credit card issuers are naturally concerned and want to be sure that credit remains available to their customers. Thus, on top of changes affecting all aspects of the business, they must also deal with the economic fallout that affects many of their customers. Fortunately, the 18-month time period provides time to cope with all these changes. If additional changes to the law or regulations were adopted and required to be implemented in a short period of time, it would disrupt an already fragile balance.

The rule adopted in December 2008 is not the end of the story. The Federal Reserve and other bank regulators will clearly monitor the implementation process. They will aggressively examine institutions for compliance. They will be able to gauge the full extent of the impact of the changes and can propose additional measures as appropriate. Even more significantly, the development and issuance of the rule has established a framework for future developments. In fact, the rule provides the necessary authority and flexibility for the Federal Reserve to take action regarding other practices that may be deemed unfair or deceptive. It is inevitable that card holder preferences will change, new payment system technologies will be developed, and competitors will offer new products and choices. We believe that this framework puts regulators in the best position to oversee and make the necessary adjustments appropriate to this dynamic market in response to the inevitable innovations in the payments system and in changes in customer preferences.

IV. Comments on the “Credit Card Accountability Responsibility and Disclosure Act”

Many of the core issues included in the “Credit Card Accountability Responsibility and Disclosure Act” (S. 3252, the 110th Congress) are already addressed by the new credit card regulations. Like the bill, the regulations prohibit rate increases on existing balances with some exceptions, bans double-cycle billing, provide more advance notice of rate changes and more time for consumers to pay bills, and require that more payments go to higher-rate balances first. While there are some differences in the details, ABA’s perspectives about the new card rules also apply to similar provisions in this bill and in other legislation. Taking a broad view, many of the significant concerns expressed by policymakers over card practices have been directly addressed by the final regulatory rules.

The bill also includes several provisions that go beyond the new rules. Please find below some of our initial thoughts with respect to these provisions. We would be happy to provide additional comments going forward.

Credit bureau reporting. [Sec. 104] The bill would prohibit furnishing information about a “newly opened” account to a credit bureau before the card has been activated by the consumer, presumably dealing with concerns that consumers may have received a card with different terms than the one for which they applied. Unfortunately, this could expose issuers to unforeseen risk. Information that an individual has applied for an account, particularly where there are multiple applications, is a factor that bears on that person’s creditworthiness and default risk. The bill would deprive issuers of this critical risk assessment information in situations where a consumer obtains new credit lines but does not immediately activate them. It also opens the door wide for fraud and identity theft. For example, identity thieves could open several new accounts under one person’s name and each of

the lenders would not have any information about the other accounts. Importantly, the opening of several new accounts is often a strong indicator of identity theft, and reporting them to consumer reporting agencies is an important way of identifying when this is occurring and so that actions can be taken to protect consumers.

Prohibition on pay to pay. [Sec. 103] The bill prohibits any separate fee to pay a bill, regardless of whether payment is made by mail, electronic transfer, telephone, or by other means. Most credit card lenders offer their customers several ways to make payments – online, through the mail, by telephone or in person at a branch, and do not charge customers for payment processing other than by telephone. Telephone payments are expensive to provide because they require manual intervention. However, the fee associated with telephone payments is primarily meant to encourage consumers to use more efficient means of payment processing, while still allowing them the option of paying by telephone and avoiding late charges. An outright prohibition on such fees would more than likely cause lenders to stop telephone payments, which means fewer options for consumers. We believe that this provision will be counterproductive and lead to fewer choices for consumers.

Tying fees to costs. [Sec. 103] The bill mandates that charges and fees for violations of card agreements (e.g., late fees, over-the-limit fees, and penalty interest increases) must be “reasonably related” to the cost of the violation to the card issuer. The ABA has serious concerns over price controls that attempt to regulate charges and fees in the private sector. These fees can be avoided altogether by careful management by consumers. Thus, in general, we believe that customers should be the ultimate arbiters regarding the appropriateness of any pricing structure and government efforts to intervene will inevitably distort the marketplace. Moreover, there are various reasons other than cost that may drive pricing. For example, just like a parking ticket may reflect fees well in excess of the cost of actually issuing the ticket for the purpose of affecting behavior (e.g., do not

park illegally), bank fees are often used to encourage appropriate behaviors, such as paying your bill on time or using more efficient services. While these fees may be in excess of costs, they serve other purposes, and again, *are easily avoided by consumers*.

Over-the-limit fee opt-out. [Sec. 103] The bill requires that consumers must be notified of their right to opt-out of over-the-limit (OTL) protection and no OTL fees can be charged for those that do. For consumers who do not opt-out, there are restrictions on when and how OTL fees may be imposed. Most consumers want over-the limit transactions to go forward – even though a fee will be charged for it. Research shows that customers value the ability to use more than their credit limit in certain situations because being declined can be both embarrassing and inconvenient. In addition, this restriction presents operational problems. Because of technical limitations, neither the credit issuer nor the merchant may know whether an authorized transaction will cause an account to exceed its credit limit. Transactions are not real-time. At the time of a particular transaction, other, earlier transactions may have not yet posted. Some merchants do not seek authorization or process the transaction online. There may be intervening transactions, such as an automatic periodic payment. In addition, merchants such as hotels and car rental agencies may have requested an authorization amount that exceeds the amount of the actual transaction, temporarily inflating the balance. For these reasons, many card issuers create a “cushion” in deciding whether a balance has exceeded the limit. Card issuers also, as a matter of competition and good service, monitor customer habits and increase limits based on customer need and eligibility.

OTL fees and credit limits are clearly disclosed, so consumers can make appropriate decisions. If a consumer does exceed his or her credit limit, the issuer should be permitted to charge the consumer as a result of the consumer’s decision to exceed the credit limit.

Five-star rating system. [Sec. 502] The GAO is required to determine whether the establishment of a five-star rating system to reflect the safety of card terms, marketing, customer service practices and product features would be beneficial to consumers. The credit card market is highly competitive and products are constantly being refined to meet consumer demands. In fact, there is no set standard on what makes a card “five stars” – one customer may want a high rewards program while not caring about interest rates; another may just focus on the interest rate. Thus, at best, any new rating system would be flawed because it cannot take into account customer priorities, making such a rating system misleading and uninformative. Further, the new Federal Reserve disclosures rules will allow customers to more easily compare different cards and chose the one that meets their needs the best, making such a rating system unnecessary. Moreover, private sector evaluations can, and do, ensure that third-party assistance to consumers on various card offerings is available, further making the creation of an expensive government bureaucracy in this area unnecessary.

Under Age 21 Restrictions. [Sec. 301-303] The bill prohibits issuing a credit card to anyone under age 21 unless the parents cosign, ability to repay is demonstrated or a financial literacy course is completed. There are also restrictions on affinity cards and prescreened offers to those under age 21. Before marketing to students or other young adults, credit card issuers undertake a thorough credit review similar to that of their general customer base. As a result, the credit performance of this portfolio is quite good. The proposed restrictions in the bill are not necessary for sound credit management and might preclude credit to numbers of young adults who in fact can handle it, and who benefit from a credit card not only for their daily transactions but also to establish a credit history. Rather than restricting their access to credit, we believe it more appropriate to teach young people how to use credit wisely and that is why ABA and our member banks strongly support financial literacy programs.

Fed Reports on Profitability and Rates. [Sec. 110] The bill amends Section 136(b) of TILA by adding several new data collection and reporting requirements for the Federal Reserve concerning credit cards. For example, the Federal Reserve must list each type of transaction for which card issuers have charged a separate interest rate. For each type of transaction, the Federal Reserve must show each distinct interest rate charged to a card holder, the number of cardholders to whom each such rate was applied and the total amount of interest charged to such cardholders. Similar data collection requirements are put in place for each type of fee charged to card holders. In addition, the Federal Reserve must report to Congress annually on the profitability of credit card operations of depository institutions, which is to include estimates of interest rates of less than 25 percent APR, equal to or more than 25 percent APR, fees on cardholders, fees on merchants and any other “material” source of income.

The bill will add unnecessary regulatory burden with little, if any, benefit, and seeks to establish a precursor to a price control system that will have government decide prices in the marketplace. This will stifle innovation and provide little benefit to consumers. We believe consumers should be the final arbiters regarding the appropriateness of any fees or interest charges in the marketplace.

Interchange Study. [Sec. 501] The GAO is required to conduct a study on interchange fees and the effect on consumers and merchants. This is an unbalanced approach that would produce questionable results. For instance, GAO is not asked to study how government interference in the market by artificially setting fees could harm consumers. There has already been some experience in this area. In Australia, the Reserve Bank of Australia (“RBA”) arbitrarily capped interchange rates. As a result, Australian merchants now pay less for payment card acceptance, but there is no evidence

that they have passed these savings on to consumers. In fact, Australian consumers now pay more for payment cards and receive fewer benefits as a result of the RBA's action.

In addition, the bill does not require GAO to study the benefits merchants receive from using the payment systems. The price that merchants pay to use these systems through the interchange fee is far below the value they receive in return. For example, it is card issuers and not merchants that absorb losses from fraud and non-payment in credit card transactions. It is important that these and other issues are included if Congress directs GAO to provide a fair and balanced study on this issue. We again caution that government intervention in price-setting in the marketplace is likely to have serious unintended consequences for consumers. This should not be taken lightly.

Conclusion

Mr. Chairman and members of the committee, ABA believes that credit cards provide an invaluable service to consumer and small businesses, and have become integral to our economic system. Any additional actions must be carefully considered so as to not further limit the availability of credit at reasonable rates to all creditworthy borrowers. This is particularly important given the current weak economy and the need for consumers to have access to credit to meet their daily needs. We stand ready to work with this committee as it continues to review the pros and cons of any further changes.

96

Written Testimony

Of

James C. Sturdevant

Principal

**The Sturdevant Law Firm
San Francisco CA 94104**

also on behalf of

The National Association of Consumer Advocates and

Before the

**SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN
AFFAIRS**

February 12, 2009

Introduction

Chairman and members of the Committee:

Thank you for the opportunity to speak about some of the current abuses in the credit card industry and to describe the problems and experiences of the everyday consumers I represent in California and elsewhere. This testimony also is presented on behalf of the National

Association of Consumer Advocates (NACA) of which I am a Board member. ¹

My Professional Background

I began my career in 1973 as an attorney with Tolland-Windham Legal Assistance Program in Willimantic, Connecticut. I worked there from September, 1972, and later at Connecticut Legal Services in Northeastern Connecticut, until May, 1978. I concentrated on class actions representing statewide groups of individuals in litigation involving welfare benefits, food stamps, housing, civil and constitutional rights, and unemployment compensation benefits. I then moved to the Los Angeles area and became director of litigation for San Fernando Valley Neighborhood Legal Services. There, I oversaw a staff of more than 25 lawyers and paralegals representing low income individuals in San Fernando Valley in individual and class action litigation involving benefit rights, employment rights, and discrimination. I entered private practice in my own firm in 1980 in Los Angeles and moved my practice to San Francisco a year later. Since then, I have concentrated my practice on consumer protection; employment discrimination; unlawful, unfair, and fraudulent business acts and practices. Major litigation that I have handled on a class action basis, both statewide in California and nationwide, has involved challenges to major credit card company practices, cases against credit card companies involved in illegal debt collection practices, cases against predatory lenders and national banks for illegal lending and debt collection practices, as well as employment discrimination, disability discrimination, Title IX litigation, and challenges to attempts by corporate entities to impose mandatory pre-dispute arbitration clauses on their customers.

¹ The National Association of Consumer Advocates (NACA) is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

I have been involved extensively for the past 20 years in legislative work before the California Legislature and Congress involving credit card practices, mandatory pre-dispute arbitration clauses, employment discrimination, National Banking Act practices, and federal preemption.

I am the past president of the Consumer Attorneys of California, the largest state organization of trial lawyers. I serve on the boards of several organizations, including the National Association of Consumer Advocates, the Lawyers' Committee for Civil Rights in San Francisco, Equal Justice Works in Washington D.C. A full and complete summary of my professional experience is contained in my resume, which I have attached to this testimony.

Real World Credit Card Abuses

Penalty Fees/Default Accounts

Daily, consumers throughout America receive collection letters claiming that s/he owes thousands of dollars on a delinquent credit card debt. Time and again, I and my fellow consumer advocates hear from clients who tell stories that mimic the facts described by the Court in *Discover Bank v. Owens*. In that case, an Ohio court found that Ms. Owens, an elderly woman who depended on a monthly Social Security Disability ("SSD") check, had more than repaid the principal balance plus interest that she had borrowed on a Discover credit card. The court rejected Discover's attempt to collect an additional \$5000 in late fees, penalty interest and credit protection costs, because those charges were, in the court's view, unconscionable.

Many of the clients who contact me depend on a monthly SSI or SSD check or are on very tight budgets because of rising costs of living and stagnant wages, a recent divorce, or a family catastrophe. These individuals and families live on the economic edge. The recent hemorrhage of jobs in all sectors, the swelling tide of foreclosures, and the abrupt halt to credit,

affects my clients directly and capriciously.

In today's economic climate, consumers nationwide have an average household income of \$52,000 and their average credit card balance exceeds \$8,500. Any change in that family's economic situation directly affects their ability to repay credit card debt. Any missed payment triggers both penalty late fees and interest rate increases. Penalty late fees currently average \$39 across the major credit card issuers. Late fee interest increases depend on the type of card, but at least double in the event of default. This happens particularly in cases where customers are marketed based on teaser or below-market initial interest rates. As the amount of debt increases for many Americans, the debt servicing costs (that includes interest and late fees) take a larger and larger toll on the American family. For some of my clients, the burdensome costs of credit make it impossible for them to stretch their income to cover surmounting debt – especially if an unexpected calamity like job loss occurs. In addition, the cost of credit is further exasperated by the fact that more and more Americans are forced to pay for basic living necessities, such as housing, food, education, gasoline, and healthcare, on credit.

The credit card industry's practice of charging high interest rates and burdensome fees weighs most heavily on Americans of modest means. These customers, like checking account customers on fixed incomes, are particularly at risk of being caught in a bottomless debt trap. For example, in *Miller v. Bank of America*, a case I tried in January/February 2004, in San Francisco Superior Court, involving the seizure by Bank of America of exempt funds from deposit accounts of elderly and disabled customers, the undisputed testimony was that the bank receives 85 percent of its bounced check or NSF fee income throughout California and throughout the nation from customers with average account balances of \$1,000 or less. The same is true in the credit card context. Credit card companies derive the great majority of their

fee income from the most vulnerable customers who are the least able to pay them.

Universal Default Clauses

The universal default provision is routinely buried in credit card agreements, whose average length today exceeds 30 pages. The agreement itself is not provided to the consumer until after the application is submitted, approved, and the card has been mailed to the consumer.

The universal default provisions that are hidden in credit card contracts provide that if the customer is in default on any obligation owed to *any entity or individual anywhere* and the credit issuer discovers this fact, the interest rate originally offered and provided to the customer skyrockets. Credit card customers assume reasonably that they may be subject to penalty fees or an increase in their credit card rate of interest if they default on the obligation with the credit card issuer itself. They do not understand that if they default on an obligation with an unrelated entity or individual, that they will be subjected to these punitive repercussions by the company with whom they have the credit card.

Universal default provisions have been roundly condemned by some individual credit card issuers, members of this committee and other members of Congress, consumer advocates, and the Federal Reserve. However, to date, this unconscionable practice continues unabated. Yes, the Federal Reserve's regulations address universal default, but they do not take effect until July 2010. The American consumer cannot wait that long for this unfair practice to be addressed.

Balance Transfers

Other customers are frequently and routinely marketed and solicited to transfer credit card balances to a different credit card company. Shortly after the transfer occurs, it is the common practice of the new issuer to increase the card's APR to a rate more than twice the one

that was offered. This occurs without any notice. I have seen it happen to customers who unfortunately transferred their balances to credit cards provided by Provident and MBNA (now owned by Bank of America). These customers were deceived by Provident and MBNA's balance transfer offers that conveniently failed to disclose material information about the terms and conditions before the credit was transferred.

For many customers, balance transfers amount to a classic unfair and deceptive practice, because the credit card issuers renege on the very promises and commitments they made when the consumers agreed to accept the card or transfer the balance.

Timing of Payments

Many customers have been sandbagged by both the "timing" or date of payment and the hour of the due date when the payment is *received* and posted. For example, one of my clients, Steve M. of Oakland, California complained to me in April 2007, that the interest rate on his Bank of America credit card had unfairly been raised from 21.24% to 32.24%. Apparently, when Mr. M. asked Bank of America for an explanation of this 50% interest rate increase, he was surprised to find out that it was because (unbeknownst to him) he had gone over his credit limit and paid \$1.50 of his debt late. He also learned for the first time that his payments were due at a Bank of America branch by 2:30 p.m. EST or they would be deemed paid the next day. Because of this, Mr. M. always made sure his payment was paid on the due date by 2:30 pm. Nonetheless, this apparently wasn't good enough for Bank of America when on February 24, 2007 (his due date) Mr. M. made a monthly payment prior to 2:30 p.m. EST. Somehow, despite the timeliness of his payment, Bank of America posted his payment on February 26, claiming that their timing rule didn't include a payment made on a Saturday, thus making his payment late. While Mr. M.'s complaints about this late fee ultimately led to its removal, it did not stop the bank from

substantially increasing his interest rate because of this “late payment.”

There has been significant litigation in California and elsewhere concerning when payments are considered timely and when payments that are made timely and posted later makes payments late under the credit card issuer’s systems. Lawsuits have been filed and settled against Citibank and Bank of America to name just two. Recently, an Appellate Court in California held the California law prohibiting payment due dates on weekends and holidays was preempted under federal law, thus, knocking out reasonable consumer protections put in place by the California legislature to protect its citizens from that type of credit card abuse. *Miller v. Bank of Am., N.A.*, --- Cal. Rptr. 3d ----, 2009 WL 189969 (Jan. 28, 2009).

I am very thankful and glad to see that Senator Dodd’s Credit Card Accountability, Responsibility and Reform Act would prohibit this type of abusive behavior that Mr. M. and countless consumers like him have suffered at the hands of the credit card companies

SKYROCKETING CREDIT CARD DEBT

The Industry and its Abuses Keep Escalating

As the above examples of credit card industry-wide abuse demonstrate and as I have seen first-and during my years of representing consumers, a significant amount of the debt of American households is caused not by consumer borrowing as such, but by the punitive – and exorbitantly expensive – tactics and practices of the credit card industry. A significant contributor to the snowballing credit card debt of American consumers is the enormous increase in both the *number* and *amount* of non-periodic interest fees charged and collected by credit card issuers. These “junk” fees include both fees considered to be finance charges (cash advance, balance transfer, wire transfer fees) and non-finance charge or “other” fees. Most widely known among the latter are late payment and over-limit fees. Other abuses include penalty interest rates

(situations in which rate increases are triggered automatically by late payments or transactions which the issuer *authorizes* exceeding credit limits on the card, deceptive marketing and arbitrary cut-off times for payment postings that cause borrowers to be charged a late fee even if the payment arrives on its due date (for example, by posting all payments at 11 a.m. so that any payment received or “posted” an hour late is deemed late).

From 1978 to 1995, credit card debt increased six-fold to \$378 billion.² In 1996, the Supreme Court paved the way for credit card banks to increase their income stream even more dramatically. In *Smiley v. Citibank (South Dakota), N.A.*, the Court approved the Office of Comptroller of Currency’s definition of interest that included a number of credit card penalty fees (imposed only in the event of default), such as late payment, over-limit, cash advance, returned check, annual, and membership fees.³ As a result, national banks and other credit card issuers are permitted to charge and collect fees in any amount to their customers as long as their home-state laws permit the fees and so long as the fees are “interest” under the Office of the Comptroller of the Currency (“OCC”) definition. Avoiding the reasonable control of many fees under state law on the amount and number of fees that credit card banks can charge nationwide has resulted in the exponential growth of and reliance on fee income by credit card issuers.

After *Smiley*, banks rushed to increase late charges, over-limit fees, and other charges. The average late payment fee soared from \$14 in 1996 to over \$32 in 2004.⁴ Over-limit fees similarly have nearly tripled from \$14 in 1996 to over \$30 in 2004⁵ and now routinely equal or

² See Fed. Res. Bull., available at http://www.federalreserve.gov/releases/g19/hist/cc_hist_mt.txt.

³ *Smiley v. Citibank (S.D.)*, Nat’l Ass’n, 517 U.S. 735, 116 S. Ct. 1730, 135 L. Ed. 2d 25 (1996). The OCC definition of interest is found in 12 C.F.R. § 7.4001(a).

⁴ Cardweb.com, Late Fees (Jan. 28, 2005), at <http://www.cardweb.com/cardtrak/news/2005/january/28a.html>.

⁵ Cardweb.com, Late Fees (Jan. 28, 2005), at <http://www.cardweb.com/cardtrak/news/2005/january/28a.html>.

exceed \$39.6

Banks impose these fees, not as a way to curb undesirable behavior from consumers – which used to be the stated justification for imposing high penalties – but as a significant source of revenue for the bank. Since *Smiley*, penalty fee revenue has increased nearly nine-fold from \$1.7 billion in 1996 to \$14.8 billion in 2004⁷ alone. The income from just three fees – penalty fees, cash advance fees and annual fees – reached \$24.4 billion in 2004.⁸ Fee income topped \$30 billion if balance transfer fees, foreign exchange, and other fees are added to this total.⁹ Concurrently, card issuer profits, though declining somewhat between 1995 to 1998; have steadily increased between 1999 and 2004. These profits rose from 3.1% in 1999 to 4.5% in 2004.¹⁰

During my thirty plus years of representing consumers I have seen the number and types of fees mushroom as well. The Federal Reserve Board provides a list of fees to consumers in a brochure titled “Choosing a Credit Card.”¹¹ The most common fees incurred in credit card transactions include:

NAME OF FEE	DESCRIPTION OF FEE
<i>Annual fee</i> (sometimes billed monthly)	Charged for having the card. Fees range from zero to \$130.

⁶ Cardweb.com, Fees & Recession (Dec. 17, 2008), at http://www.cardtrak.com/news/2008/12/17/fees_recession.

⁷ Cardweb.com, Fee Party (Jan. 13, 2005), at <http://www.cardweb.com/cardtrak/news/2005/january/13a.html>.

⁸ *Id.*

⁹ *Id.* If merchant-paid fees are combined with consumer-paid fees, the total fee income is estimated at \$50.8 billion.

¹⁰ Cardweb.com, Card Profits 04, (Jan. 24, 2005), at <http://www.cardweb.com/cardtrak/news/2005/january/24a.html>.

¹¹ Federal Reserve Board, Choosing a Credit Card, at <http://www.federalreserve.gov/pubs/shop>.

<i>Cash advance fee</i>	Charged when the card is used to obtain a cash advance; the fee is usually 3% of the advance, with a minimum of \$5 and no maximum.
<i>Balance-transfer fee</i>	Charged when the consumer transfers a balance from another credit card. Fees range from 2% to 3% of the amount transferred, with a minimum.
<i>Late-payment fee</i>	Charged if the consumer's payment is received after the due date. Fees range from \$10 to \$49.
<i>Over-the-credit-limit fee</i>	Charged if the consumer goes over the credit limit. Fees range from \$10 to \$39.
<i>Credit-limit-increase fee</i>	Charged if the consumer asks for an increase in her/his credit limit.
<i>Set-up fee</i>	One-time fee, charged when a new credit card account is opened.
<i>Return-item fee</i>	Charged if the consumer pays the bill by check and the check is returned for nonsufficient funds.
<i>Expedited payment fee</i>	Charged when the consumer makes a payment over the phone. Fees range from \$10 to \$14.95.
<i>Expedited delivery fee</i>	Charged when the consumer requests an additional credit card and requests that it be delivered in an expedited way.
<i>Replacement card fee</i>	Charged when the consumer's credit card is lost, stolen, damaged, or otherwise needs to be replaced.
<i>Additional card fee</i>	Charged when the consumer requests a card for a family member or otherwise wishes an additional card.
<i>Other fees</i>	Some credit card companies charge a fee to cover the costs of reporting to credit bureaus, reviewing the consumer's account, or providing other customer services.

The problem with these punitive charges, especially in combination with constantly increasing penalty interest rates, is that they exacerbate the economic problems for consumers

caught up in the current economic crisis. Too often these charges have driven my clients and other consumers into bankruptcy, resulting in cascading personal losses as well as losses to their families and neighborhoods – of lost savings, lost homes, forced moves, with all of the consequential financial and emotional tolls.

The top six credit card issuers engage in these abusive practices.¹² It is this pattern of heavy-handed and manipulative conduct by an entire industry that shows that credit card issuers have altered their fundamental treatment of consumers from a fair, respectful business relationship to an abusive, exploitative one.

Credit card companies were not always so free to engage in predatory, unfair, and fraudulent (if not unlawful) conduct. Credit card deregulation, and the concomitant spiraling credit card debt of Americans, began in 1978, with the Supreme Court's decision in *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.*¹³ *Marquette* gave national banks the green light to take the most favored lender status from their home state and "export" it across state lines, thereby preempting the law of the borrower's home state. As a result, national banks and other credit card issuers established their headquarters in states that eliminated or raised their usury limits, giving them free rein to charge whatever interest rate they wanted.¹⁴ Therein lies the reason why so many of those credit card solicitations sent by mail every week come from Delaware or South Dakota: credit card issuers moved there to export those unregulated states' lack of consumer protections nationwide.¹⁵ As of 1978, credit card debt had

¹² For example, see information about the civil penalties assessed against Provident and other issuers, <http://www.pirg.org/consumer/bankrupt/bankrupt2.htm>; and the recent suit initiated against Capital One by the state of Minnesota, http://www.ag.state.mn.us/consumer/PR/PR_041230CapitalOneBank_FSB.htm.

¹³ *Marquette Nat'l Bank of Minn. v. First of Omaha Serv. Corp.*, 439 U.S. 299, 99 S. Ct. 540, 58 L. Ed. 2d 534 (1978).

¹⁴ Other depository institutions obtained the same most favored lender status when Congress enacted § 521 of the Depository Institutions Deregulation and Monetary Control Act of 1980 (codified at 12 U.S.C. § 1831d).

¹⁵ South Dakota and Delaware, at the beginning of the explosive growth of the financial services industry around

grown to \$50 billion, up from just \$5.3 billion when the Truth in Lending Act was passed.¹⁶ Today, credit card debt exceeds 1 trillion.

Industry executives also have recognized escalating pricing and advertising problems in the U.S. credit card market. In 2003, Duncan MacDonald, the former general counsel for Citigroup's North American and European credit card businesses, wrote about the credit card pricing mess in the *American Banker*.¹⁷ Mr. MacDonald observed that the Office of the Comptroller of the Currency – the primary regulator of Comptroller of the Currency – the primary regulator of national banks – had “turned a blind eye to [the] lawlessness” of certain credit card issuers. He described one particular issuer, Provident, as being “well known in the card industry as the poster child of abusive consumer practices.”¹⁸ Among Provident's more shocking abuses was its imposition a \$29 per month charge for unrequested “credit protection” insurance that was worthless to the vast majority of cardholders because under the fine print it did not halt interest charges but only delayed their payment. Moreover, the practice required customers to prove their temporary disability medically.

1980, sought to attract that industry as part of their economic development strategy. They wanted to “provide [their] citizens with the jobs and benefits a large national credit card operation can provide (attracted by the ability to export limitless credit card rates to other states),” while, it should be noted, protecting their local banks from competition with the exporting banks. *Indep. Cmty. Bankers' Ass'n of S.D. v. Board of Governors, Federal Reserve Sys.*, 838 F.2d 969, 975 (8th Cir. 1988). Cf. Richard Eckman, Recent Usury Law Developments: The Delaware Consumer Credit Bank Act and Exporting Interest Under § 521 of the Depository Institutions Deregulation and Monetary Control Act of 1980, 39 Bus. Law. 1251, 1264 (1984). It worked, too. South Dakota's tax revenue from banks went from \$3.2 million in 1980 to almost \$27.2 million in 1987, with the comparable figures for Delaware rising from \$2.4 million to almost \$40 million. *The Economist*, July 2, 1988, at 26.

¹⁶ Diane Ellis, The Effect of Consumer Interest Rate Deregulation on Credit Card Volumes, Charge-Offs, and in the Personal Bankruptcy Rate, FDIC--Division of Insurance, Bank Trends, 98-05 (Mar. 1998), available at http://www.fdic.gov/bank/analytical/bank/bt_9805.html.

¹⁷ Comptroller Has Duty To Clean Up Card Pricing Mess, Letter to the Editor, Duncan A. MacDonald, *American Banker*, Nov. 21, 2003.

¹⁸ I was co-lead counsel for the Plaintiffs and the nationwide settlement class in the *Provident* credit card cases, San Francisco Superior Court, Judicial Counsel Coordination Proceeding No. 4085, a nationwide consumer class action challenging the unlawful, unfair and deceptive practices of Provident Financial Corporation, Provident Bank, Provident National Bank and Provident Bank Corp. Services in connection with the entire operation of its consumer credit card program. The Provident entities were also sued by the City and County of San Francisco and an enforcement proceeding was instituted against them by the Office of the Controller of the Currency (“OCC”) which required that Provident paid 300 million dollars to stay in business and retain its charter as a national bank.

Providian conducted a nationwide search to determine where to “best” locate its credit payment facility. It ultimately selected New Hampshire because it concluded on average it took longer for mail to reach New Hampshire over any other place in the United States. Even more shocking was Providian’s use of bar-coded return payment envelopes that used the wrong zip code for the company’s billing center. The payment envelopes literally guaranteed that cardholder payments would arrive late and, in turn, mandate a late fee on the cardholder account. Providian’s practice, in this regard, were investigated on three separate occasions by the U.S. Postal Service.

Credit card abuses were not (and are not) limited to Providian. Mr. MacDonald also decried “The Frankenstein” (his word) that had been created by the Supreme Court’s *Smiley* decision. He noted that credit card penalty fees were becoming a “substitute for APRs,” and that the industry had devolved into “trip wire pricing,” in which any cardholder misstep would set off a series of booby trap rates and penalty fees. He further observed that card pricing had become a massive subsidy for the rich. The penalty fees and rates charged to lower income cardholders -- who usually are financially unable to pay off their balances each month -- were subsidizing the cash back and frequent flyer perks used to entice the super-creditworthy, who typically do not carry monthly balances.

Credit card debt has caught millions of Americans in a trap they simply cannot extricate themselves from without feeling the pressure to file bankruptcy. At the same time, credit card earnings have been consistently higher than returns on all commercial bank activities.¹⁹ The problem is not the profits, it is simply that these profits are based on abusive practices, and resulting harm inflicted upon American households. The root of these problems is that credit

¹⁹ Board of Governors of the Federal Reserve System, *The Profitability of Credit Card Operations of Depository Institutions* (June 2004), available at <http://www.federalreserve.gov/boarddocs/rptcongress/creditcard/2004/ccprofit.pdf>. While the profitability of the credit card industry as a whole has fluctuated somewhat over these years, this is largely due to the changeability of the group of banks included in the sample. *Id.* at 2.

card transactions in this nation are now completely unregulated – and this must change.

Mandatory Arbitrations Clauses Limit Access To Justice

Additionally, many credit card companies have been and are now using mandatory arbitration clauses to circumvent basic due process protections and to obtain default judgments against consumers in distant forums. In California and Pennsylvania, for example, several credit card issuers obtained default arbitration awards against dozens of consumers from a Minnesota arbitration company, the National Arbitration Forum, that they attempted to have enforced by the courts. The courts found that the method of service for the arbitrations and the distant forum did not comply with basic due process rules, analogizing the arbitrations to long-outlawed confessions of judgment. *See, e.g., Patterson v. IIT Consumer Fin. Corp.*, 14 Cal.App.4th 1659, 18 Cal. Rptr. 2d 563 (1993).

Many State and some federal courts have concluded that the prohibition of class actions or class wide adjudication is unconscionable.²⁰ In truth and in economic reality, few if any consumers can take on an allegedly deceptive credit card practice individually. The stakes are just not high enough for any one consumer, and the time commitment alone far outweighs any potential economic award. I hear from my colleagues all the time that no lawyer can handle an individual consumer credit card complaint, because his or her factual investigation will nearly always exceed in time and money the amount that could be recovered for the individual consumer. These were the precise findings of the California Supreme Court in the *Discover Bank* case, the Washington State Supreme Court in the *Scott* case and the District Court in Ninth Circuit in the *Ting* case.

²⁰ *See Ting v. AT&T*, 182 F.Supp.2d 902 (N.D. Cal. 2002), *aff'd in part* 319 f.3d 1126 (9th Cir.), *cert denied*, 540 U.S. 811 (2003); *Discover Bank v. Superior Court* (2005) 36 Cal.4th 148, 113 P.3d 1100; *Muhammad v. County Bank of Rehoboth Beach, Delaware* (2006) 189 N.J. 1, 20-21, 912 A.2d 88, *cert denied* 127 S.Ct. 2032; *Scott v. Cingular Wireless* (Wash. 2007) 161 P.3d 1000, 1006.

As described in more detail in my resume, my firm represented the plaintiffs in *Badie v. Bank of America*, 67 Cal.App.4th 779, 79 Cal.Rptr.2d 273 (Cal. App. 1st Dist., 1998) and the *Ting* litigation. Both cases were challenges to the attempts of Bank of America and AT&T, respectively, to impose binding mandatory pre-dispute arbitration clauses on millions of their consumer customers. Both cases resulted in published decisions which held with respect to Bank of America that its attempt to change a material term - "elimination of the right to trial by jury" via a bill stuffer was inadequate where there was no evidence that the provisions in the bill stuffer had come to the attention of any customers other than the four individual plaintiffs in the case and in *Ting* that AT&T's attempts to oppose a binding mandatory pre-dispute arbitration clause coupled with numerous provisions unconscionable under California law was invalid. The abuses detailed in these and other cases would be eliminated through the Arbitration Fairness Act, as introduced by Representative Hank Johnson and Senator Russ Feingold.

Credit Card Debt Pushes Borrowers Into Bankruptcy

In 2003 Congress enacted draconian and unbalanced bankruptcy legislation. As a result of this new law, bankruptcy relief is now more complicated and more expensive for every individual who needs it. Despite the breathtaking scope of the new law, it did not place a single constraint on abusive practices by creditors. Yet, a large body of evidence links the rise in consumer bankruptcies over the last twenty years or so to a direct increase in consumer debt. And, as the examples of abusive credit card practice in this statement demonstrate, a substantial portion of that consumer debt can be attributed to sky high interest rates, penalties and fees that credit card companies tack on to the bills of consumers each month.

After years of experience with the new bankruptcy law, Congress should eliminate some of the unnecessary and costly burdens it has placed on financially struggling families seeking

relief from debts they cannot pay.

PROPOSED SOLUTIONS

More Disclosure Is Not the Answer

Because of the deregulation of bank credit, virtually no state regulation on creditor conduct applies to the practices of the credit card industry.²¹ While there are some – very few – limits placed on the most outrageous abuses of consumers by banks by the federal banking regulators, the Truth in Lending Act (“TILA”) is the primary regulatory structure applicable to the relationship between credit card issuers and their customers. The TILA was intended to be – and remains – primarily a disclosure statute. Through its enactment and enforcement, Congress intended to enable consumers to compare the costs of credit.²² However, the TILA was never intended to stand on its own – to be the sole and primary means of regulating and limiting a powerful industry vis-à-vis the individual consumers who borrow money for personal, family or household purposes. Indeed, when the TILA passed in 1968, state usury and fee caps applied to credit card transactions.

Uniform and accurate disclosures are useful for consumers, but they are no meaningful substitute for real regulation. The best proof of this is the unbalanced and dangerous situation that the American consumers find themselves in with the open-end credit industry today.

Disclosures can never and should never replace outright statutory prohibitions of established and well documented credit card abusive and insidious credit card practice. Disclosures are only useful for consumers when all of the following conditions exist –

- The consumer has the opportunity to read the disclosures fully;

²¹ For example, when the state of California tried to address the issue of tiny minimum payments by requiring creditors to provide information to each consumer on how long it would take to pay off a sample credit card balance if only the minimum payment was paid each month, a federal district held the statute was preempted by federal banking statutes. *Am Bankers Ass'n v Lockyer*, 239 F. Supp.2d 1000 (E.D. Cal 2002).

²² 15 U.S.C. § 1601(a).

- The disclosures are unambiguous and understandable;
- The disclosures are true and apply to the entire term of the contract;
- The consumer has the knowledge and sophistication to understand the meaning of the information provided in the disclosures; and
- The consumer has the opportunity to make choices based on the information gained through the disclosures.

Moreover, disclosures alone are not sufficient to protect consumers from overreaching creditors. This is because --

- Consumers lack equal access to information – most consumers will not have the knowledge to understand the legal consequences of the terms of credit.
- Consumers lack any real bargaining power – no consumer has the market power to call up a credit card company and negotiate either the basic terms or those in the adhesion contract.
- The credit card market does not provide real choices. With the increasing consolidation of credit card providers, the industry guarantees less meaningful competition. There is generally competition only on the surface, on a few prominently-advertised terms such as the periodic rate and annual fee.
- Consumers have little or no meaningful choices on the terms that create the bulk of the cost of open-end credit.
- Without basic substantive regulation, there will continue to be competition between industry players only as to which can garner the most profit from the most consumers – regardless of the fairness, or the effects on consumers.

Recommendations for Statutory Reform

The credit card market in the U.S. is extraordinarily mature. To increase market share, industry participants are extremely aggressive in their pricing strategies. Because the APR is the primary measure of competitiveness, back-end penalty fees will continue to increase in numbers and dollar amount to offset the risks in credit card marketing plans. Consumers do not, however, shop for credit cards based on their penalty fees, and no real competition will ever exist to decrease the escalation of those fees with Congressional retribution of prohibition. To restore real competition based on the APR, all bank penalties should be controlled by the longstanding common law rules on penalties – the fees are capped by the actual or reasonably expected cost to the bank from a cardholder’s breach. This is the principles-based standard reiterated for such fees by the Office of Fair Trading in the United Kingdom and Europe, and it should be applied here as well. Without such an approach, we will continue to see a race to the bottom for backend penalties while the banks deceptively tout unrealistically low APRs.

Accordingly, it is time for the Congressional re-regulation of credit card transactions. Real, substantive limits on the terms of credit, and the cost of the credit, including the interest rate and all fees and charges, must be re-imposed. These include:

- A cap on all periodic interest rates, for example, prime plus 10%.
- A cap on all other charges, whether considered a finance charge or not, to an amount the card issuer can show is reasonably related to cost.
- No unilateral change-in-terms allowed.
- No retroactive interest rate increases allowed.
- No penalties allowed for behavior not directly linked to the specific card account at issue.
- No over limit fees allowed if issuer permits credit limit to be exceeded.

- No improvident extensions of credit—require real underwriting of the consumer’s ability to pay.
- No mandatory arbitration, either for consumers’ claims, or for collection actions against consumers.
- Meaningful penalties for violating any substantive or disclosure requirement that provide real incentives to obey the rules.
- A private right of action to enforce section 5 of the Federal Trade Commission Act, which prohibits unfair or deceptive practices by businesses, including banks.

It is no longer a question of balancing the appropriate regulation with the need to assure access to credit. The increasing mountain of debt held by American consumers, coupled with the growing number of abusive practices by the credit card companies, illustrate amply de-regulation has not worked. Since biblical times government has recognized that consumers need strong, enforceable limits placed on the power of lenders to exert their far greater bargaining power in the marketplace. The age old protection of borrowers from over-reaching lenders needs to be reinstituted. We look forward to working with Chairman Dodd and other members of this committee to develop and enact this year strong, effective credit card legislation.

TESTIMONY OF
PROFESSOR TODD J. ZYWICKI
PROFESSOR OF LAW
MERCATUS CENTER SENIOR SCHOLAR
GEORGE MASON UNIVERSITY
SCHOOL OF LAW

3301 Fairfax Dr.
Arlington, VA 22201
Phone: 703-993-9484
Fax: 703-993-8088

Before the
United States Senate
Committee on Banking, Housing,
And Urban Affairs

Modernizing Consumer Protection in the Financial Regulatory
System: Strengthening Credit Card Protections

Thursday, February 12, 2009

10:00am

Room 538 Dirksen Senate Office Building

This testimony with all Figures and the academic articles referenced herein are available for download on my website at <http://mason.gmu.edu/~tzywick2/>.

TODD J. Zywicki is Professor of Law at George Mason University School of Law, Editor of the *Supreme Court Economic Review*, Mercatus Center Senior Scholar, Goldwater Institute Senior Fellow, Senior Fellow of the James Buchanan Center, Program on Politics, Philosophy, and Economics. He is also a member of the Board of Directors and Advisory Council of the Financial Services Research Program at George Washington University. From 2003-2004, Professor Zywicki served as the Director of the Office of Policy Planning at the Federal Trade Commission. He teaches in the area of Bankruptcy, Contracts, Commercial Law, Business Associations, Law & Economics, and Public Choice and the Law. He has also taught at Georgetown Law Center, Boston College Law School and Mississippi College School of Law and is a Fellow of the International Centre for Economic Research in Turin, Italy. He has lectured and consulted with government officials around the world, including Italy, Japan, and Guatemala. Professor Zywicki has testified several times before Congress on issues of consumer bankruptcy law and consumer credit. Professor Zywicki is a Member of the United States Department of Justice Study Group on "Identifying Fraud, Abuse and Errors in the United States Bankruptcy System." He is the author of the forthcoming books, *Bankruptcy and Personal Responsibility: Bankruptcy Law and Policy in the Twenty-First Century* (Yale University Press, Forthcoming 2007) and *Public Choice Concepts and Applications in Law* (West Publishing, Forthcoming 2008).

Professor Zywicki clerked for Judge Jerry E. Smith of the U.S. Court of Appeals for the Fifth Circuit and worked as an associate at Alston & Bird in Atlanta, Georgia, where he practiced bankruptcy and commercial law. He received his J.D. from the University of Virginia, where he was executive editor of the Virginia Tax Review and John M. Olin Scholar in Law and Economics. Professor Zywicki also received an M.A. in Economics from Clemson University and an A.B. cum Laude with high honors in his major from Dartmouth College.

Professor Zywicki is the author of more than 70 articles in leading law reviews and peer-reviewed economics journals. He is one of the Top 50 Most Downloaded Law Authors at the Social Science Research Network, both All Time and during the Past 12 Months. He served as the Editor of the *Supreme Court Economic Review* from 2001-02. He is a frequent commentator on legal issues in the print and broadcast media, including the *Wall Street Journal*, *New York Times*, *Nightline*, *The Newshour with Jim Lehrer*, CNN, CNBC, Bloomberg News, BBC, *The Diane Rehm Show*, and *The Laura Ingraham Show*. He is a contributor to the popular legal weblog The Volokh Conspiracy. He is currently the Chair of the Academic Advisory Council for the following organizations: The Bill of Rights Institute, the film "We the People in IMAX," and the McCormick-Tribune Foundation's "Freedom Museum" in Chicago, Illinois. He was elected an Alumni Trustee of the Dartmouth College Board of Trustees.

It is my pleasure to testify today on the subject of “Modernizing Consumer Protection in the Financial Regulatory System: Strengthening Credit Card Protections.” The growth in the consumer use of credit cards over the past three decades has transformed the American economy, placing in consumers’ hands one of the most powerful financial innovations since the dawn of money itself. Credit cards have transformed the ways in which we shop, travel, and live. They have enabled the rise of the E-Commerce economy, delivering goods and services to consumers’ doorsteps and permitting consumers to shop when and where they like, unconstrained by traditional limits on competition and consumer choice. They have enabled consumers to travel the world without the inconvenience of travelers’ checks. And they have transformed the way in which we live, from such small improvements such as relieving us the inconvenience of checks and frequent visits to ATM machines to large improvements such as providing security against crime. Credit cards can be used as a transactional medium, a source of credit, or even as a short-term source of cash. Credit cards provide consumers with additional benefits, from cash back on purchases, frequent flier miles, car rental insurance, dispute resolution services with merchants, and 24 hour customer service. It has been aptly observed that that with a credit card you can buy a car; without a credit card you can’t even rent one. Many of these benefits, of course, have been most salient for lower-income, young, and other similar populations, and unsurprisingly, growth in credit card use has been rapid among those populations.

But the myriad uses of credit cards and the increasing heterogeneity of credit card owners has spawned increasing complexity in credit card terms and concerns about confusion that may reduce consumer welfare. American consumers encounter

complexity every day in the goods and services they purchase, such as cars, computers, and medical services, just to name a few. And the complexity of credit card terms is modest when compared to that of the Internal Revenue Code, as are the penalties (financial and otherwise) for failure to understand its terms. The relevant issue for regulation, therefore, is whether the complexity is warranted in light of the benefits.

In considering whether further legislation or regulation of credit card terms or disclosures is appropriate, two questions should be considered. First, what is the problem to be corrected through regulation? And second, will the benefits of the regulation justify the costs, including the unintended consequences of the regulation?

This is not to imply that certain credit card issuers or practices are not or may not seem unfair or improper. But there are ample tools for courts and regulators to attack deceptive and fraudulent practices on a case-by-case basis when they arise. Unlike case-by-case common law adjudication, however, legislation or regulation addresses itself to *categorical* rulemaking, thus before categorical intervention is warranted it is necessary to examine whether categorical problems have arisen.

I have taught and written extensively on questions related to credit cards, consumer credit generally, and the relationship between consumer credit and consumer bankruptcies. Several years ago I published *The Economics of Credit Cards*, 3 CHAPMAN L. REV. 79 (2000).¹ I have also published *An Economic Analysis of the Consumer Bankruptcy Crisis*, 99 NORTHWESTERN L. REV. 1463 (2005),² as well as *Institutions, Incentives, and Consumer Bankruptcy Reform*, 62 WASHINGTON & LEE L. REV. 1071

¹ Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=229356.

² Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=587901.

(2005).³ I am currently working on a book on consumer credit and consumer bankruptcy tentatively titled *Bankruptcy Law and Policy in the Twenty-First Century* to be published by the Yale University Press, from which portions of this testimony are drawn. I am honored to have the opportunity to share my research with you here today. From 2003-2004 I served as Director of the Office of Policy Planning of the Federal Trade Commission.

What is the problem to be corrected through regulation?

Advocates of greater regulation have alleged three problems that are purported to justify additional regulation of the credit card market: (1) Consumer overindebtedness caused by access to credit cards, (2) Unjustifiably “high” interest rates on credit cards, and (3) A growing use of so-called “hidden” fees. Reviewing the empirical evidence available on these issues, however, there is no sound evidence that any of them present a meaningful problem for which substantially greater regulation is appropriate.

(1) Consumer Overindebtedness

The expressions of concern heard today about credit cards were presaged in similar paternalistic comments about the spread of installment credit.⁴ Installment selling was criticized for allegedly inducing overconsumption by American shoppers, especially supposedly vulnerable groups such as “the poor, the immigrant, and the allegedly math-impaired female.”⁵ Rapacious installment sellers were accused of extending credit to unworthy borrowers, leading them to purchase unnecessary products and generating

³ Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=681483.

⁴ CALDER, *supra* note **Error! Bookmark not defined.**, at 211.

⁵ CALDER, *supra* note **Error! Bookmark not defined.**, at 166.

debts beyond their means to repay.⁶ Department stores were criticized for “actively goad[ing] people into contracting more debt.”⁷ In 1873 the *New York Times* expressed concern that Americans were “Running in Debt” and by 1877 warned that Americans were “Borrowing Trouble.”⁸ In 1873 a labor leader bemoaned the improvidence of America’s consumers, “Has not the middle class its poverty? Very few among them are saving money. Many of them are in debt; and all they can earn for years, is, in many cases, mortgaged to pay such debt.”⁹ An 1899 report concluded that installment selling “‘lured thousands to ruin’ encouraging people to buy what they could not pay for and making debt ‘the curse of countless families.’”¹⁰ And not merely the poor and improvident were lured into ruin, but upstanding middle class families as well, as they engaged in a heated rivalry of conspicuous consumption with their neighbors.¹¹ In 1949 *Business Week* asked, “Is the Country Swamped with Debt?” and by 1959 *U.S. News and World Report* worried that “Never Have So Many Owed So Much.” In 1940 *Harper’s* even feared that “Debt Threatens Democracy.”¹²

The criticisms of mid-century installment credit mirrored those of credit cards today: easy access to installment credit allegedly generated overconsumption, overindebtedness, and finally bankruptcy. Credit customers bought more goods than

⁶ See CALDER, *supra* note Error! Bookmark not defined., at 182.

⁷ CALDER, *supra* note Error! Bookmark not defined., at 217.

⁸ Quoted in DAVID S. EVANS AND RICHARD SCHMALENSEE, *PAYING WITH PLASTIC: THE DIGITAL REVOLUTION IN BUYING AND BORROWING* 101 (2d ed. 2005).

⁹ CALDER, *supra* note Error! Bookmark not defined., at 59 (quoting Ira Steward).

¹⁰ CALDER, *supra* note Error! Bookmark not defined., at 213.

¹¹ CALDER, *supra* note Error! Bookmark not defined., at 215. The term “conspicuous consumption” was coined over a century ago. See THORSTEIN VEBLEN, *THE THEORY OF THE LEISURE CLASS: AN ECONOMIC STUDY OF INSTITUTIONS* (1899). Veblen argues that one effect of conspicuous consumption is a tendency for households to reduce savings and to rely on debt to live beyond their means.

¹² Quoted in EVANS & SCHMALENSEE, *supra* note 8, at 101.

cash customers¹³ and retailers were criticized for enabling shoppers to buy more on credit than they normally would on cash.¹⁴ Installment selling was considered a “menace” that trapped Americans in “a morass of debt” and was the “first step toward national bankruptcy,” a further overture to today’s criticisms of credit cards.¹⁵ Moreover, although most Americans believed that installment selling was a “good idea” in general and were confident in their own ability to use it responsibly, three out of four also thought that their neighbors used installment credit excessively¹⁶—a judgment mirrored in modern surveys of consumers about credit card use, in which most consumers assert confidence in their own ability to use credit cards responsibly but express concern about the ability of others to do the same.¹⁷ And as consumer bankruptcy filings rose during the 1960s, some commentators and politicians pointed the finger of blame at profligate installment lending.¹⁸ These criticisms of installment credit provide ironic reading today in light of the modern claim that the ubiquity of credit cards—which have come to displace installment credit for many consumer transactions—allegedly has produced a psychology of consumer overconsumption.¹⁹

There is no doubt that consumer use of credit cards has increased over time, as has credit card debt. But available evidence reveals that this increase in credit card debt has not in fact resulted in an increased financial distress for American households.

¹³ CALDER, *supra* note **Error! Bookmark not defined.**, at 200.

¹⁴ CALDER, *supra* note **Error! Bookmark not defined.**, at 220; compare MANN, *supra* note.

¹⁵ CALDER, *supra* note **Error! Bookmark not defined.**, at 221. The use of debt to purchase consumption goods such as food was thought to be especially irresponsible. CALDER, *supra* note **Error! Bookmark not defined.**, at 225.

¹⁶ CALDER, *supra* note **Error! Bookmark not defined.**, at 235.

¹⁷ Thomas A. Durkin, *Credit Cards: Use and Consumer Attitudes, 1970–2000*, 86 FED. RES. BULL. 623,628–30 (2000).

¹⁸ See *Wage Earner Plans Under the Bankruptcy Act: Hearing on H.R. 1057 and H R 5771 Before the House Committee on the Judiciary*, 90th Cong. (1967).

¹⁹ See, e.g., MANN, *supra* note **Error! Bookmark not defined.**, at 46; Richard L. Wiener, et al., *Consumer Credit Card Use: The Roles of Creditor Disclosure and Anticipated Emotion*, 13 J. EXPERIMENTAL PSYCHOLOGY: APPLIED 32 (2007).

Instead, this increased use of credit cards has been a *substitution* from other types of consumer credit to an increased use of credit cards.²⁰ For instance, when consumers in earlier generations purchased furniture, new appliances, or consumer goods, they typically purchased those items “on time” by opening an installment loan and repaying the loan in monthly payments or through a layaway plan. A consumer who needed unrestricted funds to pay for a vacation or finance a car repair would typically get a loan from a personal finance company or a pawn shop. Today, many of these purchases and short-term loans would be financed by a credit card, which provides ready access to a line of credit when needed, without being required to provide a purchase-money security interest, dealing with the up-front expense and delay of a personal finance loan, or pawning goods.²¹ Credit cards are far more flexible and typically less-expensive than these alternative forms of consumer credit, thereby explaining their rapid growth in consumer popularity over time. Federal Reserve economist Tom Durkin observes that credit cards “have largely replaced the installment-purchase plans that were important to the sales volume at many retail stores in earlier decades,” especially for the purchase of appliances, furniture, and other durable goods.²² Former Federal Reserve Chairman Alan Greenspan similarly observed, “[T]he rise in credit card debt in the latter half of the 1990s is mirrored by a fall in unsecured personal loans.”²³

²⁰ See Zywicki, *Bankruptcy Law and Policy*, Chapter 3.

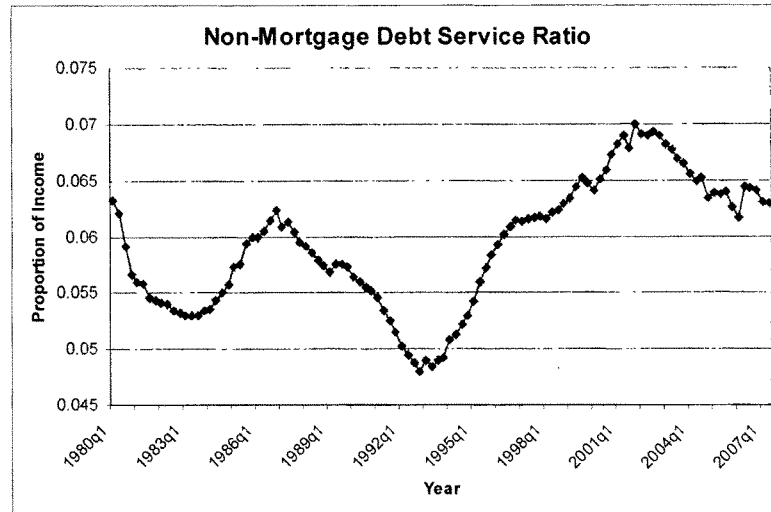
²¹ Wal-Mart recently announced, for instance, that it was terminating its once-popular layaway program. Like other major department stores, Wal-Mart acknowledged that this form of credit had become irrelevant because of widespread access to credit cards. Unlike layaway, purchasing goods using a credit card permits the consumer to use the goods while paying them off, whereas under layaway the store keeps the goods until they are paid for.

²² See Thomas A. Durkin, *Credit Cards: Use and Consumer Attitudes, 1970–2000*, 86 FED. RES. BULL. 623 (2000).

²³ Alan Greenspan, *Understanding Household Debt Obligations*, Remarks Given at the Credit Union National Association 2004 Governmental Affairs Conference (Feb. 23, 2004), available at <http://www.federalreserve.gov/boarddocs/speeches/2004/20040223/default.htm>.

In fact, the evidence suggests that the growth in credit cards as a source of consumer credit is explained almost completely by this substitution effect. Thus, even as credit card use has risen rapidly over time, it does not appear that this has contributed to any increase in consumer financial distress.²⁴

Since 1980, the Federal Reserve has calculated on a quarterly basis the “debt service ratio,” which measures the proportion of a household’s income dedicated each month to payment of its debts. Consider the following chart (data through 3rd Quarter 2007):²⁵



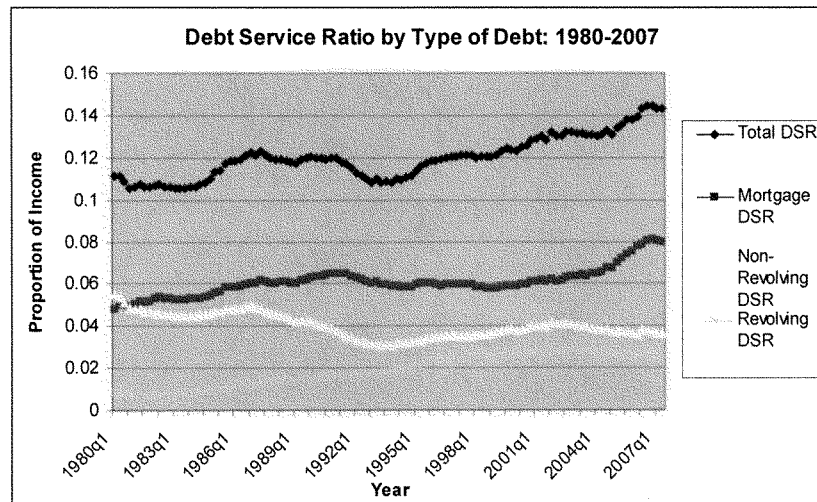
As this figure illustrates, the overall debt service ratio for non-mortgage debt (consumer revolving plus nonrevolving debt) has fluctuated in a fairly narrow band

²⁴ Accord BOARD OF GOVERNORS OF THE FEDERAL RESERVE, REPORT TO CONGRESS ON PRACTICES OF THE CONSUMER CREDIT INDUSTRY IN SOLICITING AND EXTENDING CREDIT AND THEIR EFFECTS ON CONSUMER DEBT AND INSOLVENCY 5 (June 2006) (hereinafter FEDERAL RESERVE REPORT).

²⁵ Unless otherwise indicated, all data presented herein is drawn from the Federal Reserve Board.

during the period 1980 to 2006 (the small scaling distorts the overall impression). In fact, the non-mortgage debt service ratio was actually slightly higher at the beginning of the data series in 1980 (0.0633) than at the end in the first quarter of 2006 (0.0616) with local peaks and troughs throughout.

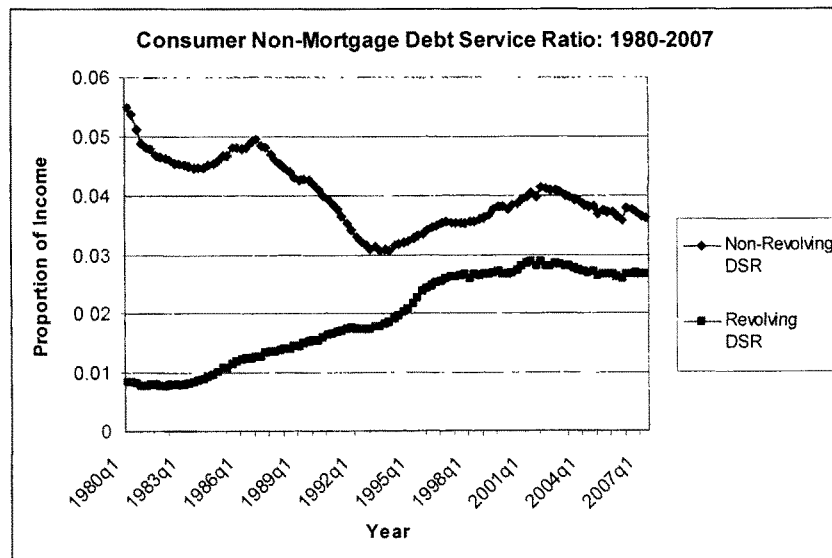
Further isolating non-mortgage consumer debt into revolving and nonrevolving components illustrates the substitution effect:



As can be readily observed, from 1980 there has been a gradual downward trend in the debt service burden of nonrevolving installment credit, such as car loans, retail store credit (such as for appliances or other consumer goods) and unsecured loans from personal finance companies, that mirrors the upward trend for the credit card debt service burden over this same period, leaving the overall consumer credit debt service ratio unchanged. Moreover, according to the Survey of Consumer Finances, the percentage of

households in financial distress (as measured by a total debt service ratio, including mortgage credit, of greater than 40%) has fluctuated within a narrow band since 1989.²⁶

Decomposing just the consumer credit portion of household indebtedness reveals the substitution effect, exhibiting the rise in credit card credit in the 1980s to be offset by a near mirror-image of the fall in the installment debt burden during that same time:



This substitution effect of credit card for other types of consumer credit has been most pronounced for lower-income debtors, primarily because this group historically has faced the most limited credit options; thus, credit cards are likely to seem especially attractive to them. As a report of the Chicago Federal Reserve Bank concluded, "The increase in the credit card debt burden for the lowest income group appears to be offset by a drop in the installment debt burden. This suggests that there has not been a substantial increase in high-interest debt for low-income households, but these

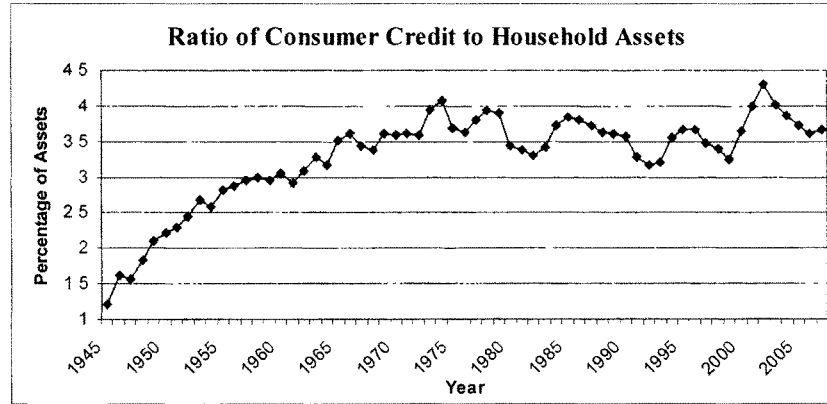
²⁶ FEDERAL RESERVE REPORT at 13.

households have merely substituted one type of high-interest debt for another.”²⁷ As with the overall population, the percentage of lowest-quintile households in financial distress has been largely constant since 1989, and in fact, the percentage of lowest-income households in financial distress is actually at its lowest level since 1989.

In fact, it is likely that this data actually tends to *overestimate* the contribution of revolving debt to the debt service ratio, because of peculiarities in the way in which the debt service ratio is measured. First, there has been a dramatic increase in household wealth holdings over the past decade or so, first because of the roaring stock market of the late-1990s, and then the rapid appreciation in housing values into the 2000s. Because consumers rationally borrow against and consume some percentage their accumulated wealth, during periods of rapidly increasing household wealth (such as during the 1990s) consumers would be expected to increase their consumption and consumer debt in order to liquidate some of this accumulated wealth. The ratio of consumer credit to household net worth has been about 3.5% of household assets for about the past forty years, thus as consumer wealth rises consumers will tend to increase their debt holdings even though their measured income does not increase.²⁸

²⁷ Wendy M. Edelberg & Jonas D. M. Fisher, *Household Debt*, CHI. FED. LETTER, Nov. 1997, at 1, 3 (1997); see also *id.* at 4 (“[I]ncreases in credit card debt service of lower-income households have been offset to a large extent by reductions in the servicing of installment debt.”); Arthur B. Kennickell et al., *Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances*, 83 FED. RES. BULL. 17 (1997) (noting that the share of families using installment borrowing fell between 1989 and 1995 as a result of increased use of mortgages, credit cards, and automobile leasing); Glenn B. Canner & James T. Fergus, *The Economic Effects of Proposed Ceilings on Credit Card Interest Rates*, 73 FED. RES. BULL. 1, 4 (1987) (noting that rise in credit card use may have been the result of “a substitution of credit card borrowing for other types of installment credit that do not provide flexible repayment terms”).

²⁸ See Thomas A. Durkin, Comment, in *THE IMPACT OF PUBLIC POLICY ON CONSUMER CREDIT* 36, 40 (Thomas A. Durkin and Michael E. Staten eds., 2002). Data in chart provided by Durkin.



Second, the data used here to measure revolving credit likely tends to overestimate the true amount of revolving credit because of a rise in transactional use over time, an overestimation that tends to grow over time. Revolving credit is measured by the credit card balance *outstanding* at the end of a given month, regardless of whether it is actually revolved or paid off at the end of the billing cycle. As a result, the data also report as part of outstanding revolving credit balances on transactional accounts that will be paid at the close of the billing cycle, but happen to be outstanding at the time of reporting. Because some of this transactional debt is still outstanding at the end of the month, it is recorded as an outstanding debt balance and thus an increase in transactional credit card use will artificially increase the measured amount of revolving credit and overstate revolving credit as a percentage of income.

Transactional or “convenience” use of credit cards as a purchasing rather credit medium has been rising over time, both in terms of number of credit card transactions as well as dollar values. During the past 15 years, convenience use grew by approximately 15% per year, whereas the amount borrowed on credit cards as revolving credit grew

only about 6 ½% per year.²⁹ In part, the increase in transactional use of credit cards has been driven by the spread of rewards cards, such as cash-back programs or frequent flyer miles.

The mismeasurement of transactional credit card use as credit card borrowing tends to overstate credit card debt by approximately ten percent, a figure that has doubled in the past decade as a result of the rapid rise of credit card convenience use.³⁰ The percentage of credit card transactions that are paid off at the end of each month relative to those that end up revolving has risen over time, indicating a growth in convenience use. In addition, the median monthly charge amount for convenience users has risen over four times more rapidly for convenience users than for revolvers. The median monthly charge for convenience users has increased by about \$130 (from \$233 in 1991 to \$363 in 2001), whereas the average charge of revolvers is substantially smaller and has increased more slowly, rising only \$30 during that same time period (from \$117 to \$147). Again, much of this growth in the median size of transactional purchases probably results from a rise in cash-back and cobranding benefits. In addition, because convenience users do not have to pay for their purchases until the end of the billing period *plus* the grace period after receiving their bill, they have the opportunity to take advantage of interest rate “float” during the time between their purchase and payment of the obligation, which may be as long as 45-60 days. During that period, a transactional user essentially receives a free loan from the credit card issuer at zero percent interest³¹ during which time those same funds can be invested in assets that generate a positive return, even if only a money

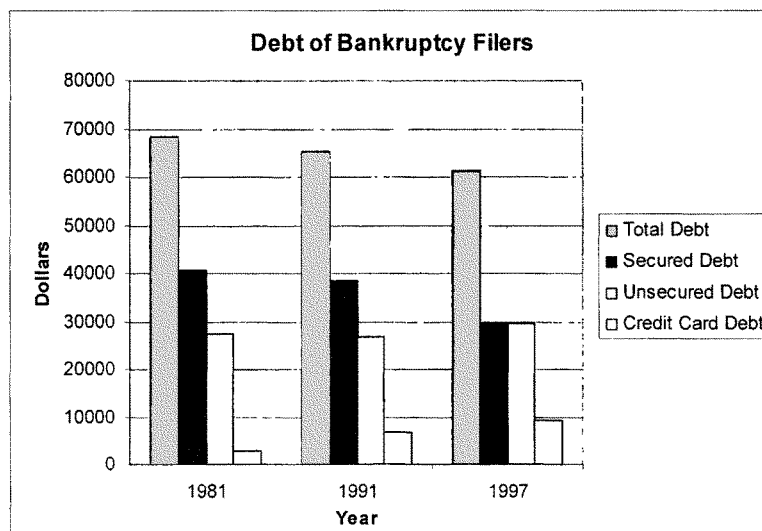
²⁹ Kathleen W. Johnson, *Convenience or Necessity? Understanding the Recent Rise in Credit Card Debt*, Finance and Economics Discussion Series, Federal Reserve Board, 2004-47.

³⁰ See Johnson, *Convenience or Necessity?*

³¹ Technically the interest rate is slightly negative because of the time value of money.

market account or similar safe, short-term investment. In fact, empirical evidence tends to suggest that consumers do exactly this—convenience users tend to carry smaller precautionary balances in their checking accounts than revolvers, suggesting that they are taking advantage of this float. In addition, revolvers are more likely to make use of debit cards than are nonrevolvers, which can be explained by the fact that revolvers do not receive the benefit of interest-rate float because they are required to pay the full interest on the account.³²

The substitution effect is seen even among those who file bankruptcy. Consider the following data drawn from Sullivan, et al.:



As can be seen, from 1981 to 1997 the average amount of total debt held by bankruptcy filers remained constant, but the ratio of credit card debt to total unsecured

³² Jonathan Zinman, *Why Use Debit Instead of Credit? Consumer Choice in a Trillion Dollar Market*. Brown and Plache find that 62 percent of revolvers who acquired a general purpose debit card actually used that card whereas only 37 percent of nonrevolvers used their debit card. See Tom Brown & Lacy Plache, *Paying with Plastic Maybe Not So Crazy*, 73 U. CHICAGO L. REV. 63, 84 (2006).

debt increased, suggesting a substitution between credit card debt and other unsecured debt. Sullivan, et al., find that in 1981, total debt for bankruptcy filers was \$68,154, of which unsecured debt was \$27,365.³³ By 1997, mean total debt among bankruptcy filers had actually fallen slightly to \$61,320 and unsecured debt rose slightly to \$29,529. Although total debt and total unsecured debt remained relatively constant, mean credit card debt among bankruptcy filers rose from \$3,635 to \$14,260 during this period and median credit card debt rose from \$2,649 to \$9,345.³⁴ Thus, the substitution effect is evident among bankruptcy filers specifically, as credit card debt has risen even as total debt and total unsecured debt have remained largely constant. Credit card debt nonetheless remains a small fraction of overall household debt for bankruptcy filers.

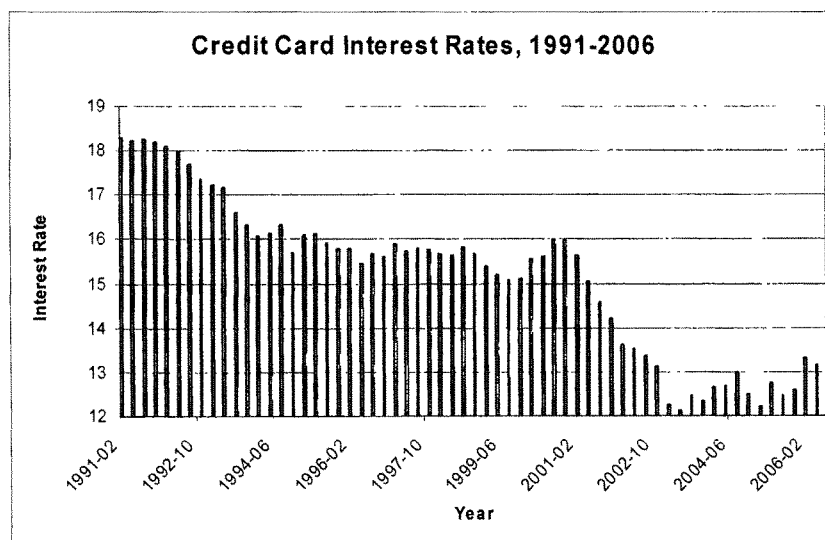
Overall, therefore, there is no evidence that increased use of credit cards has caused consumers as a whole to become overindebted. In fact, the rise in credit card use is the result of a substitution away from other less-attractive forms of credit (because of cost, flexibility, or other drawbacks such as the need to pawn personal goods) to credit cards.

(2) “High” Credit Card Interest Rates

³³ See SULLIVAN, ET AL., FRAGILE, *supra* note **Error! Bookmark not defined.**, at 66, Table 2.4. All values are in 1997 dollars.

³⁴ *Id.* at 122, Table 4.1. The 1981 figures include only bank-type cards whereas the 1997 figures include all credit card debt. As noted, during this period there was a general substitution from other types of credit cards to bank-type cards, thus the 1981 figures may underestimate total credit card debt. In 1991, the mean debt for bank-type cards only among bankruptcy filers was \$11,529, thus using the same category as 1981 there was plainly a large increase in bank-type card debt during the 1980s.

Many commentators insist that the growth in credit card use as a source of revolving credit is irrational in light of the “high” interest rates charged on credit cards.³⁵ But credit card interest rates have fallen substantially over the past fifteen years:



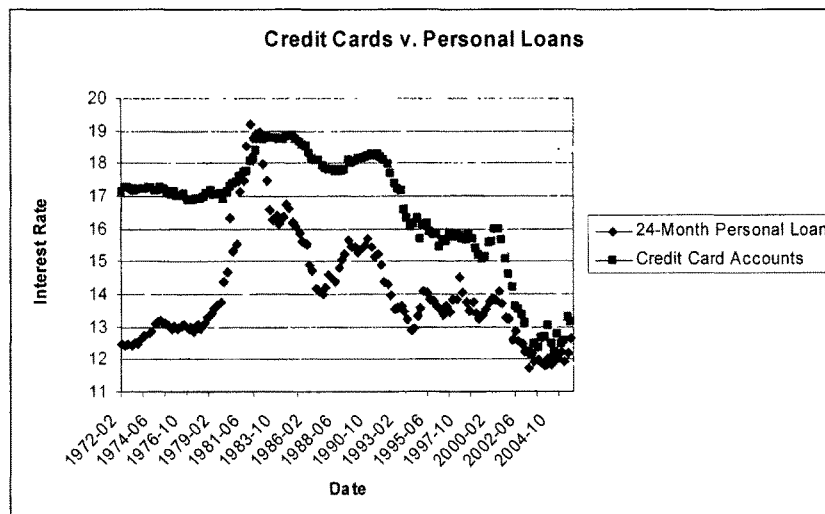
Annual fees, which were once a standard component of credit card contracts, virtually disappeared from credit cards during this period, except for those cards that offer frequent flier miles or some other benefit program that requires some administrative activity.³⁶ This elimination of annual fees, which were in the range of \$20-\$50 per year, was a massive across-the-board price reduction that not only reduced the cost of credit cards to consumers, but also increased competition in the credit card market by making it

³⁵ Note that if the interest rates really were higher on credit cards than on the types of credit that they supplant, then one would expect this to be reflected in a higher debt-service ratio, which as we have just seen, it is not.

³⁶ GAO REPORT at 23. The GAO Report noted that some cards offered rewards but still did not charge annual fees.

easier and less-expensive for consumers to carry multiple cards and to use the cheapest or most appropriate card for any given transaction.

This rapid decline in credit card interest rates explains the substitution from other types of consumer credit. Compare credit cards to the closest alternative to credit card borrowing, the traditional short-term unsecured installment loan, such as from a personal finance company. The following Figure displays interest rates on 24-month unsecured installment loans versus credit card interest rates for the past thirty years:



As can be readily observed, the difference between interest rates on short-term personal installment loans and credit card accounts has narrowed over time. Indeed, in recent years the interest rate on credit card accounts has frequently fallen below that of short-term personal loans. A recent survey of consumer banking rates in the Washington, D.C., area found the prevailing interest rate on credit cards was 8.16%, whereas the

prevailing rate for personal loans was 10.45%.³⁷ Moreover, once up-front initiation fees on personal loans are taken into consideration the overall cost of personal loans is almost certainly higher overall.³⁸ And this doesn't even consider the time, inconvenience, and more limited usefulness of a personal finance loan, or the more flexible repayment option of credit cards. According to one survey conducted by the Federal Reserve, 73% of consumers report that the option to revolve balances on their credit cards makes it "easier" to manage their finances versus only 10% who said this made it "more difficult."³⁹

This decline in credit card interest rates has resulted from robust competition in the credit card market and savvy shopping by consumers. Survey evidence indicates that consumers who revolve credit card balances are extremely likely to be aware of the interest rate on their credit cards and to comparison shop among cards on that basis, and those who carry larger balances are even more likely to be aware of and comparison shop on this term than those who revolve smaller balances.⁴⁰ By contrast, those who do not revolve balances tend to focus on other aspects of credit card contracts, such as whether there is an annual fee, the grace period for payment, or benefits such as frequent flier miles. In fact, consistent with the observation of more aggressive interest rate shopping

³⁷ The *Washington Times* reports area consumer banking rates each Friday. Data is drawn from those published reports.

³⁸ Brito and Hartley reported, for instance, "A senior bank officer told us that the costs to the bank of processing a loan are so high that they cannot afford to make a loan of less than \$3,000 for one year except at interest rates *above* those charged on credit cards." They also note, "inquiries in Houston in February 1992 revealed rates ranging from 17 percent and a \$100 fixed fee for a collateralized 1-year loan at a branch of a major national finance company to over 50 percent for small loans (\$300 maximum) at a local finance company." In short, bank loans of similar size and duration "either do not exist or are available only at terms more onerous than those offered by credit card issuers." By contrast, credit cards generally require no application fee and no minimum loan size. See Dagobert L. Brito & Peter R. Hartley, *Consumer Rationality and Credit Cards*, 103 J. POL. ECON. 400, 402 (1995).

³⁹ Durkin, *Credit Cards: Use and Consumer Attitudes* at 623.

⁴⁰ See Thomas A. Durkin, *Credit Card Disclosures, Solicitations, and Privacy Notices: Survey Results of Consumer Knowledge and Behavior*, FEDERAL RESERVE BULLETIN p. A 109 (2006).

by revolvers, those who revolve balances are charged *lower* interest rates on average than those who do not.⁴¹

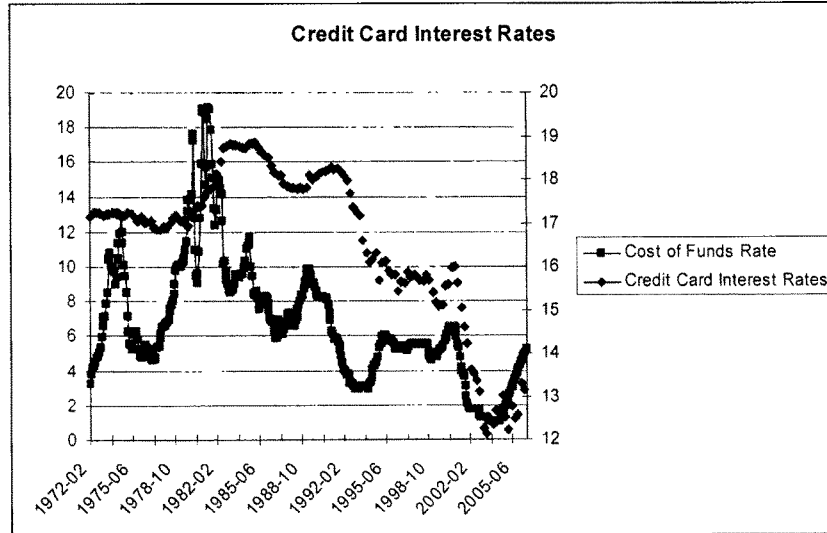
Empirical evidence indicates that credit card interest rates also generally reflect changes in the riskiness of credit card lending. Thus, when credit card chargeoffs increase, the spread charged between the underlying cost of funds and the interest rate rises.⁴²

Furthermore, credit card interest rates have become less “sticky” over time, indicating that technological and risk-scoring innovations as well as more flexible risk-based pricing (as detailed below) has made credit cards even more responsive to competitive pressures. According to the General Accounting Office 93% of the cards they examined in 2005 had variable interest rates—a rise of 9 percentage points in just two years.⁴³ As a result, interest rates on credit cards have become more closely tied to overall interest rates in the economy, as illustrated in the following Figure.

⁴¹ Tom Brown & Lacey Plache, *Paying with Plastic: Maybe Not So Crazy*, 73 U. CHICAGO L. REV. 63 (2006).

⁴² See Adam B. Ashcraft, Astrid A. Dick, and Donald P. Morgan, *The Bankruptcy Abuse Prevention and Consumer Protection Act: Means-Testing or Mean Spirited?* Working Paper, Federal Reserve Bank New York (Dec. 19, 2006).

⁴³ GENERAL ACCOUNTING OFFICE, CREDIT CARDS: INCREASED COMPLEXITY IN RATES AND FEES HEIGHTENS NEED FOR MORE EFFECTIVE DISCLOSURES TO CONSUMERS 15 (Sept. 2006).



As can be seen, interest rates on credit cards historically were relatively “sticky,” when compared to other types of interest.⁴⁴ But note in particular that interest rates on credit cards were *equally sticky* throughout the *entire period* of 1972-1989. The era of the 1970s, of course, was an era of dramatically *increasing* interest rates – essentially the mirror opposite of the falling interest rates of the 1980s. During the period 1972-1982, the federal funds rate rose from a monthly low of 3.29% in February 1972 to a high of 19.10% in June 1981. Annual averages ranged from 4.43% in 1972, steadily increasing to 16.38% in 1982, before they started falling again. Thus, credit card interest rates were *also* sticky during the 1970s and early-1980s despite a *rising* cost of funds rate. Regardless of whether the cost of funds rate is rising or falling, for a period of 20 years the interest rate on credit cards has remained relatively constant, until the decline in interest rates in recent years. If credit card issuers were reaping large profits off the

⁴⁴ An extended discussion of the explanation for the traditional stickiness of credit card interest rates is provided in Todd J. Zywicki, *The Economics of Credit Cards*, 3 CHAPMAN L. REV. 79 (2000).

“spread” between the cost of funds and interest rates in the 1980s, they by definition were suffering equally large losses during the 1970s and the early 1980s. In fact, during this period, the average return on credit card operations was lower than for other sectors of banking activity. So, in general, whether the cost of funds rate has been rising or falling, interest rates on credit cards have been much less responsive to changes in the cost of funds than have other forms of consumer credit.

In recent years, however, credit card interest rates became much more responsive to changes in the cost of funds rate during this period. Beginning with the final quarter of 1994 to the present, the interest rates on credit cards became tied much more closely to the cost of funds rate rose, and for credit card accounts actually assessed interest, the fit is even tighter, again likely reflecting the higher emphasis placed on this term by revolvers when shopping for cards.⁴⁵

On the whole, therefore, there appears to be no evidence of any market failure with respect to interest rates on credit cards. Competition and increasingly sophisticated consumer choice have brought about lower and more responsive interest rates over time. Alternative types of consumer credit offer similar interest rates, but often higher fees and more inconvenience than do credit cards.

(3) Fees and Other Price Terms

Interest rates on credit cards have fallen and become more flexible during the past decade, but during that same time period late fees, overdraft fees, and other fees have

⁴⁵ See Kathleen Johnson, *recent Developments in the Credit Card Market and the Financial Obligations Ratio*, FED. RES. BULLETIN 473, 477 (Autumn 2005) (noting that correlation between credit card interest rates and the prime rate was only 0.09 during the 1980s and early 1990s but has risen to 0.90 from mid-1990s to present).

risen in frequency and amount. These fees remain only a relatively small percentage of issuers' revenues, however, only amounting to about 10% of issuers' revenues, whereas interest payments still amount to about 70% of revenues.⁴⁶ The remainder of revenue is generated by merchant discount fees and the like. Moreover, although the GAO was able to find some isolated instances where assessment of these fees imposed an undue hardship on particular consumers, it was unable to find any systematic evidence of categorical abuse or misuse of these fees.

This increased use of penalty fees arose during the same time period that credit card interest rates both became lower and more flexible. This does not appear to be a coincidence. Evidence indicates that, in general, these fees are risk-based fees triggered by actual borrowing behavior and when used in combination with interest rates provides issuers with greater flexibility in pricing credit terms than relying on interest rates alone. Interest rates are generally an *ex ante* before the fact estimate of a given borrower's likelihood of default. Late fees, over-limit fees, and other similar fees, by contrast, are more tightly tied to the borrower's exhibited risky behavior. The only systematic empirical study of these fees of which I am aware concludes that these fees are risk-based and complement interest rates for efficient risk pricing.⁴⁷ Massoud, Saunders, and Scholnick find, for example, that a one standard deviation in bankruptcy per capita leads to an increase in penalty fees of \$0.62 to \$1.31. Similarly, a one standard deviation change in the chargeoff ratio was found to change late fees in a range of \$4.35 to \$7.57. In addition, they find that a 1 basis point reduction in card interest rates will result in an increase in penalty fees of between 0.88 and 4.11 cents. Thus, in their study, a one

⁴⁶ GAO REPORT at 70-72.

⁴⁷ See Nadia Massoud, Anthony Saunders, and Barry Scholnick, *The Cost of Being Late: The Case of Credit Card Penalty Fees*, working paper (January 2006).

standard deviation in credit card interest rates (273 basis points) was estimated to change late fees by \$2.40. Moreover, they found no evidence that assessed penalties were larger for low-income borrowers.

The increased use of risk-based fees has occurred at the same time as increased variable-rate pricing on credit cards, as the combination of these two pricing mechanisms is evidently more efficient than interest rates alone. In addition, it appears that consumers who pay these fees are not surprised by their existence, but are aware of them before they enter into the transaction that triggers the fee.⁴⁸

In addition, if credit card penalty fees were actually some sort of new form of consumer abuse, rather than simply a more accurate pricing scheme, then this tradeoff between higher risk-based fees and lower interest rates would result in larger economic rents or “economic profits” to the banking industry. In fact, return on assets has been largely constant for credit card banks over the past two decades, even though there has been a steady rise in the returns of other commercial banks.⁴⁹ Thus, during the early days of credit cards, issuers relied heavily on annual fees that were assessed on all cardholders, regardless of risk. During the 1990s, issuers phased out widely-disliked annual fees and moved toward greater emphasis on interest rates that were more closely tied to borrower risk. The gradual increase in the use of risk-based fees to supplement interest rates has made credit pricing reflect risk still further. This suggests that the transition to more risk-based pricing has come about through market competition, resulting in more efficient pricing of credit terms to consumers. First, there was a general phasing out of annual fees

⁴⁸ See Durkin, *Credit Card Disclosures* at p. A114.

⁴⁹ See GAO REPORT at 76. For a discussion of the special difficulties in inferring credit card “profits” from the standard analysis of “return on assets” used in the banking industry, see Zywicki, *The Economics of Credit Cards*.

and greater emphasis on interest rates, then recent years has seen a gradual increase in the use of penalty fees to further more closely tailor price to cardholder risk.

Cost-Benefit Analysis and Unintended Consequences

Available evidence indicates that the credit card market is competitive and responsive to consumer choice. Understanding the economics of the credit card market therefore raises serious challenges for any proposals to heighten regulation of the credit card market. In fact, misguided regulation can have serious unintended consequences that will end up reducing consumer welfare; thus, any proposal for additional regulation should be studied carefully to ensure that the benefits of any such regulation exceed the costs, including any unintended consequences that such regulation is likely to spawn. In addition, it would be wise to examine the continuing relevance and utility of existing regulations before proposing new regulations.

There are three basic manners in which credit can be regulated: substantive regulation, disclosure regulation, or market and common law “regulation.” Each has costs and benefits.

Substantive Regulation

The oldest and hoariest type of regulation of consumer credit is substantive regulation of credit terms, such as usury restrictions that cap the rate that can be charged on interest rates. Substantive regulation of terms is generally frowned upon today, as thousands of years of economic history has generally demonstrated that the costs of substantive regulation generally exceed any benefits that it would generate.

In particular, there are three predictable unintended consequences that result from substantive regulation of consumer credit terms: (1) term substitution and repricing, (2) product substitution, and (3) rationing. Each of these three would likely manifest themselves in response to efforts to place new regulations on credit cards.

(1) Term Substitution and repricing: Credit card contracts are complicated, multiple-term contracts. Term substitution refers to the phenomenon that regulation of some terms of this multiple-term contract will cause issuers to adjust other terms in order to reach the market clearing “price.” Even in the relatively short history of credit cards, history is littered with examples.⁵⁰ Prior to the Supreme Court’s decision in *Marquette National Bank v. First of Omaha Corp.*, 439 U.S. 299 (1978), most consumer credit card contracts were governed by usury restrictions that capped the interest rate that could be charged on credit cards. As interest rates generally rose during the 1970s, this rate ceiling meant that card issuers could not charge a market rate of interest on their consumer loans. The era witnessed a number of offsetting term repricing adjustments by credit card issuers, all of which almost certainly made consumers worse off. First, issuers imposed annual fees on all cards to make up for the shortfall from the inability to charge a market rate of interest. Not only was this an inefficient pricing mechanism because it wasn’t calibrated to borrower risk, it also forced transactional users of credit cards to subsidize revolvers who were able to borrow at the sub-market interest rate. Similarly, retailers would bury their credit losses by marking up the price of the goods they sold on credit; for instance, states with stricter usury ceilings also had higher retail prices for appliances. Usury restrictions also had a number of other unfortunate negative impacts

⁵⁰ See Zywicki, *Economics of Credit Cards* for an extended discussion.

on consumers. Customer benefits were lower in states with stricter usury ceilings, such as shorter banking hours and the elimination of other services such as free Christmas gift wrapping at department stores. Moreover, this term substitution also had the effect of making credit more heterogeneous in nature, making it more difficult and expensive for consumers to compare prices and shop. Most notably, annual fees made it more expensive for cardholders to carry more than one card, thereby making it difficult to switch from one card to another that presented a better deal.

The immediate aftermath of *Marquette* was the opportunity for credit card issuers to charge a market rate of interest for their products. In turn, this led to the rapid elimination of annual fees, which were no longer necessary to offset regulatory caps on interest rates. In turn, this enabled greater competition and consumer choice, which eventually resulted in a fall in a proliferation of card variety, lower interest rates, and heightened competition. According to a study by Thomas Durkin of the Federal Reserve, 90% of consumers report that they are “Very” or “Somewhat Satisfied” with their credit cards.⁵¹ Given the ease of comparison shopping and the wide variety of cards in the marketplace, it should not be surprising that most consumers have found products and issuers with which they are largely satisfied.

Empirical evidence strongly suggests that efforts to place substantive limits on credit card pricing today would likely generate similar offsetting term substitution. As noted, empirical evidence indicates that penalty fees imposed by credit card issuers are generally tied to consumer risk and as a result have an offsetting effect on interest rates. Any regulatory efforts to cap or otherwise regulate late fees, overlimit fees, and the like,

⁵¹ Thomas Durkin, *Consumers and Credit Disclosures: Credit Cards and Credit Insurance*, FEDERAL RESERVE BULLETIN (April 2002).

would therefore almost certainly lead to increased interest rates for all consumers, or other offsetting adjustments in credit contract terms. It is not readily apparent why regulators would seek to impose a regulatory scheme that forces responsible and less-risky borrowers to pay higher interest rates to subsidize irresponsible and risky borrowers who pay their bills late or exceed their credit limits. This cross-subsidization is especially unfair to low-income but responsible borrowers who would otherwise be lumped into the same interest rate category as these other borrowers. In fact, the GAO Report indicates that at least one credit card issuer is experimenting with a credit card that would eliminate all penalty fees—but in exchange would impose a much higher interest rate (above 30 percent) if the cardholder pays late or otherwise defaults on the terms of the card.⁵² Thus, while there appears to be some isolated instances of penalty fees run amuck, blanket regulatory limitations on these fees will likely make credit card pricing less efficient and harm overall consumer welfare.

(2) Product Substitution: Notwithstanding the ability of credit card issuers to readjust uncontrolled terms of the credit card contract to try to price credit efficiently, in some situations the inability to charge efficient risk-based prices will make it impossible to extend credit card credit to some borrowers. Nonetheless, Americans need access to credit to deal with life's surprises, such as the need for unexpected car repairs, medical bills, to furnish a new apartment, or simply for a student to buy an interviewing suit to seek a job. If these individuals are unable to get access to credit cards, experience and empirical evidence indicates that they will turn elsewhere for credit, such as pawn shops,

⁵² GAO REPORT at 24.

payday lenders, rent-to-own, or even loan sharks.⁵³ As noted above, there is no evidence that more widespread access to credit cards has worsened household financial condition because this growth in credit has been a substitution from other types of consumer credit.

It is hard to see how a college student or any young American is made better off by being denied a credit card and thus forced to furnish her apartment through a rent-to-own company. Nor is it readily apparent to me how a lower-income family who needs schoolbooks or a clarinet for their child is made better off by being forced to borrow from a payday lender or pawn shop to make ends meet. The young and the poor already have fewer and less-attractive credit options than middle class families—restricting their credit options still further by making it even more difficult for them to get access to attractive credit on competitive terms does not seem to be a plausible way of making their lives better.

(3) Rationing: Finally, if issuers are unable to reprice terms so as to reach a market-clearing price for all consumers, and those consumers are unable to get needed credit from pawn shops, loan sharks, and other less-attractive lenders, the eventual result will be that some Americans will lack access to much-needed credit. This is the well-established finding of thousands of years of economic history, going back at least to Ancient Greece. What of the person who needs access to credit to repair a broken

⁵³ See Susan Lorde Martin & Nancy White Huckins, *Consumer Advocates v. The Rent-to-Own Industry: Reaching a Reasonable Accommodation*, 34 AM. BUS. L.J. 385 (1997); Signe-Mary McKernan et al., *Empirical Evidence on the Determinants of Rent-to-Own Use and Purchase Behavior*, 17 ECON. DEV. Q. 33, 51 (2003); James P. Nehf, *Effective Regulation of Rent-to-Own Contracts*, 52 OHIO ST. L.J. 751, 752 (1991); Eligio Pimentel, *Renting-To-Own. Exploitation or Market Efficiency?*, 13 LAW & INEQ. J. 369, 394 (1995); LENDOL CALDER, FINANCING THE AMERICAN DREAM; JOHN P. CASKEY, FRINGE BANKING: CHECK-CASHING OUTLETS, PAWNSHOPS, AND THE POOR 37-67 (1994); RICHARD L. PETERSON & GREGORY A. FALLS, IMPACT OF A TEN PERCENT USURY CEILING: EMPIRICAL EVIDENCE (Credit Research Ctr., Working Paper No. 40, 1981); see also Robert W. Johnson & Dixie P. Johnson, *Pawnbroking in the U.S.: A Profile of Customers* 47 (Credit Research Ctr., Monograph No. 34, 1998)

transmission so that he can get to work? In the end, at least some consumers are going to be forced to survive without credit that will allow them to repair their car, buy braces for their children, or Christmas presents for their relatives. Simply wishing that he could have access to credit on terms favored by regulators will not make it so and it is not clear what policy benefit is gained by pretending otherwise.

Disclosure Regulation

The drawbacks of substantive regulation of consumer credit terms are well-understood. As a result, it has become increasingly common to mandate certain disclosures, rather than to impose substantive regulations on consumer credit. Evidence suggests that some disclosures, like the requirement of disclosing the APR for credit card loans, has tended to facilitate consumer awareness of competing credit offers and thus to shop for the best deal available.⁵⁴

But as with substantive regulation, there is a trade-off to increased mandatory disclosures. Consumers have limited attention for reading disclosures and issuers have limited space and expense for making disclosures. Thus, mandating some disclosures necessarily makes it more difficult to disclose fully other card terms that some consumers may care more about or may make it more difficult for consumers to find the information that they care about.

For instance, approximately half of American consumers do not revolve a balance on their credit cards. For those consumers, the APR is a completely irrelevant term in shopping for and using a card. And the evidence suggest that in fact transactional users of credit cards pay much less attention to the APR and Finance Charge than do those who

⁵⁴ See Durkin, *Credit Card Disclosures*.

revolve balances (and the larger the balance the more attention is paid).⁵⁵ Transactors generally care more about other aspects of cards, such as grace periods, benefits (such as car rental insurance or purchase price protection), and any rewards they offer (such as frequent flier miles or cash back). Although requiring disclosure of information of interest rates is certainly useful for those who shop on that basis for the other half of card users who do not revolve balances it is simply unnecessary clutter that makes it more difficult for them to locate the information that they want from a card issuer.

Moreover, experience demonstrates that once disclosures are mandated, they become very difficult to update in light of changing circumstances. This can be a particular problem in rapidly-evolving markets such as the credit card market. For instance, the “Schumer Box” requires disclosure of useless or trivial information such as the amount of the minimum finance charge, which according to the GAO Report, was typically about 50 cents. Other mandatory disclosures, such as the method for computing balances, may be too complicated or of little importance to most consumers in choosing among cards.⁵⁶ The GAO Report observes that the outdated structure of the Schumer Box, TILA, and Regulation Z make it difficult to accurately and effectively disclose many of the new terms on credit cards that have been described, rendering such disclosures less helpful than would otherwise be the case.

Nonetheless, trivial, outdated, or irrelevant disclosures are given the same importance as other more important terms, and newly important terms are difficult to disclose at all. For mandatory disclosures to be an effective tool for facilitating consumer choice, rather than a counterproductive distraction and threat of information overload,

⁵⁵ Durkin, *Credit Card Disclosures* at p. A 113.

⁵⁶ GAO REPORT at 54.

regulators must be committed to updating them swiftly and regularly in order to keep up with rapid changes in the market and consumer preferences.

Still another problem with the actual practice of disclosure regulation is the apparent effort to use disclosure regulation as a “back door” version of substantive regulation, to try to guide consumers in the “right” direction. Thus, although it is recognized that usury restrictions are counterproductive, it is implicitly assumed that forcing disclosure of the “high” rate of interest will shock consumers into moderating their credit use, along the lines of “If consumers *only knew* how much they were paying in interest, they would borrow less.” A related problem is mandating disclosures in order to advance some political or social goal, rather than to facilitate careful and responsible consumer borrowing. Thus, Congress recently mandated the disclosure of the amount of time it would take to pay off a cardholders existing balance assuming that only the minimum payment were made. Federal Reserve economist Thomas Durkin estimates that this disclosure actually will be useful to only 4% of cardholders who state that they actually intend to stop adding new charges to the card and to repay their balance by making only the minimum payment.⁵⁷ Although this disclosure effects a very small number of consumers—who could otherwise get the same information simply by calling their credit card issuers—it will necessitate still further expense by cardholders and further increase the costs to consumers of locating the information that they actually care about. Properly implemented, standardized disclosure may facilitate autonomous consumer choice by making it easier for consumers to comparison shop among credit products. But efforts to use disclosure as a back door version of substantive regulation is

⁵⁷ Thomas A. Durkin, *Credit Cards: Use and Consumer Attitudes, 1970-2000*, FED. RES. BULLETIN 623, 634 (Sept. 2000).

likely to be ineffective at bringing about the desired substantive outcome, while simultaneously failing to provide the useful information to consumers that disclosure regulation should produce.

Finally, according to another study by Durkin, two-thirds of credit card owners find it “very easy” or “somewhat easy” to find out information about their credit card terms, and only six percent believed that obtaining this information was “very difficult.” Two-thirds of respondents also reported that credit card companies usually provide enough information to enable them to use credit cards wisely and 73% stated that the option to revolve balances on their credit card made it “easier” to manage their finances versus only 10% who said this made it “more difficult.” Finally, 90% of credit card owners were “Very” or “Somewhat Satisfied” with their credit cards, versus only 5% who were “Somewhat Dissatisfied” and only 1% percent—that’s 1 out of 100—who were “Very Dissatisfied.”

In short, consumers seem overwhelmingly satisfied with their credit cards, the information they receive from credit card issuers, and ease with which they can get information about their cards. Credit card issuers appear to have the incentives to provide timely and accurate information to consumers and by all accounts appear to be doing so.

Market Competition and Common Law as Regulation

It must also be kept in mind that market competition is a form of regulation as well. The credit card market is extremely competitive, with thousands of issuers constantly competing to woo consumers with better offers. Consumers routinely carry as

many as four credit cards in their wallets, ready to switch immediately to the card that offers a more attractive package of benefits and terms. In such a market, it is unlikely that oppressive or unfriendly contract terms would last, and in fact this seems to be the case. The GAO Report found, for instance, that only 3 of the 28 cards that they examined had “universal default” clauses in 2005.⁵⁸ The GAO Report also found that between 2003 and 2005 only a minority of credit card issuers used the so-called “double-cycle billing method” of calculating finance charges and I understand that even those issuers have eliminated that scheme today.⁵⁹ In addition, only 2% of cards charge annual fees, and virtually all of them provide some rewards program in return. In fact, annual fees traditionally have been the cost of credit cards most despised by consumers—in fact, when annual fees were first implemented in the 1970s, consumers cancelled 8% of their credit cards immediately.⁶⁰

In addition, courts have used traditional common law rules and contract remedies to punish fraudulent or deceptive practices by card issuers. This has been quite efficacious in protecting consumers and raises further questions about the need for additional regulation.

Thus, although issuers may try to impose on consumers a variety of disagreeable terms, the ease with which consumers can shift from one card to another, and the heated competition among issuers for consumer loyalty, renders such a scenario relatively implausible. Whether annual fees, universal default clauses, or “double-cycle billing,” the market appears to be largely self-correcting in terms of delivering to consumers the

⁵⁸ GAO REPORT at 26.

⁵⁹ GAO REPORT at 28.

⁶⁰ See Zywicki, *Economics of Credit Cards*.

credit card products that they desire—which explains the 90 percent positive satisfaction rate described above.

Behavioral Economics and the Modern Case for Regulation

Some commentators nonetheless have argued that this substitution by consumers to greater reliance on credit cards is evidence of widespread consumer irrationality rather than a beneficent process of market competition.⁶¹ But these arguments ignore the very possibility of a substitution effect, implicitly assuming that all debt has been piled upon preexisting consumer debt burdens. It also is implicitly assumed that there must have been an increase in debt burdens, both because of an increase in indebtedness as well as a belief that credit cards impose higher interest rates than the types of credit that they replaced.

It is also asserted that credit cards are uniquely prone to consumer irrationality and overspending. But this argument usually is not based on a comparison to the alternative types of consumer credit that they replaced, such as installment or “open book” store credit or even retail store credit cards, which were widely-owned in the 1970s and which were subject to identical criticisms in earlier generations. Some scholars argue that credit cards are more prone to biases of “hyperbolic discounting” than installment credit.⁶² But why would a consumer be more prone to hyperbolic discounting bias when a purchase is made on a credit card with the full balance to appear on the statement and become due in full the next month as opposed to an installment loan where

⁶¹ See Bar-Gill, *supra* note **Error! Bookmark not defined.**, Bar-Gill offers no empirical support for his contentions and his theoretical model rests on some problematic assumptions. See Joshua D. Wright, *Behavioral Law and Economics, Paternalism, and Consumer Contracts: An Empirical Perspective*, 2 N.Y.U. J. LAW & LIBERTY 470, 485-88 (2007).

⁶² Michelle J. White, *Bankruptcy Reform and Credit Cards*, 21 J. ECON. PERSPECTIVES 175, 181-82 (2007).

the full price of the loan is concealed in monthly payments that may stretch out over many months or even years, especially when the price of credit is obscured in the price of the goods?⁶³ As noted at the outset, earlier generations criticized installment credit on precisely this basis. White focuses on the fact that the payments under installment loans are regularized, but the issue of hyperbolic discounting is salient at the time the loan is made, not when it is repaid. Student loans, for instance, are installment loans but it would be difficult to argue that students anticipate the full cost of those loans more rationally than for credit cards. Moreover, unlike many installment loans, credit card loans can be easily refinanced for a better interest rate by switch balances to lower-rate cards.

As noted, complaints about the perceived irrationality or short-sightedness of “other consumers” is as ubiquitous as credit itself, whether the product was installment loans in mid-Twentieth Century America or credit cards today. Consumers today surely are at least as sophisticated at using and shopping for credit as in the past and the ubiquity of credit advertising has made informed shopping easier than ever.⁶⁴ In fact, consumer behavior involving credit cards appears to be generally consistent with rational economic behavior. Revolvers are more aware of their interest rates and more likely to comparison

⁶³ For instance, consumers are often unable to understand the full cost of traditional installment loans such as the APR and related terms. See JAMES M. LACKO & JANIS K. PAPPALARDO, FED. TRADE COMM’N., IMPROVING CONSUMER MORTGAGE DISCLOSURES: AN EMPIRICAL ASSESSMENT OF CURRENT AND PROTOTYPE DISCLOSURE FORMS 35 (2007); Jinkook Lee and Jeanne M. Hogarth, *The Price of Money: Consumers’ Understanding of APRs and Contract Interest Rates*, 18 J. PUB. POL’Y AND MARKETING 66 (1999); Diane Hellwig, Comment, Exposing the Loansharks in Sheep’s Clothing: Why Re-Regulating the Consumer Credit Market Makes Economic Sense, 80 NOTRE DAME L. REV. 1567, 1591-92 (2005) (summarizing studies).

⁶⁴ Federal Reserve Economist Kathleen Johnson notes, for instance, that over the past decade credit card users have become less myopic in terms of their household financial planning. See Johnson, *Transactions Demand*, *supra* note **Error! Bookmark not defined.**, at 13-15. Moreover, as noted, increased competition among payday lenders tends to decrease the price of these loans, suggesting some degree of shopping behavior even among those borrowers. See *supra* note **Error! Bookmark not defined.**, and accompanying text. In a hyper-competitive environment such as the credit card environment, shopping is even easier for consumers.

shop among cards on that basis than others, and those who carry larger balances are even more likely to be aware of their interest rate and comparison shop on this term than those who revolve smaller balances.⁶⁵ Revolvers are more likely than convenience users to read credit card solicitation material, and a larger proportion of revolvers said that they would apply for a card with a lower rate if it were offered, and the larger the outstanding balance the more likely the cardholder would be apply for a lower-rate card.⁶⁶ Revolvers are more likely to hold a credit card with an annual fee but a lower interest rate than are transactional users.⁶⁷ In fact, as illustrated above in Figure 9 and as others have found, this competition is so intense that credit card pricing today actually illustrates an inversion of interest rates—revolvers actually tend to have interest rates that are *lower* on average than nonrevolvers.⁶⁸ According to the Survey of Consumer Finances the median interest rate on the household credit card with the largest balance was 11.5 percent in 2004, a drop of 3.5% from 2001.⁶⁹ Consumers also have become increasingly savvy about exploiting “teaser rate” offers by “card surfing” from one teaser rate card to the other.⁷⁰ Those who do not revolve balances, by contrast, tend to focus on other terms of

⁶⁵ See Thomas A. Durkin, *Credit Card Disclosures, Solicitations, and Privacy Notices: Survey Results of Consumer Knowledge and Behavior*, FEDERAL RESERVE BULLETIN p. A 109, 112-A115 (2006) (80% of revolvers examine APR frequently compared to 40% of transactors); Zywicki, *Economics of Credit Cards*, *supra* note **Error! Bookmark not defined.**, at 104-09; Randall J. Pozdena, *Solving the Mystery of High Credit Card Rates*, 42 FRBSF WEEKLY LETTER 2 (1991).

⁶⁶ Durkin, *supra* note 65, at A117; Glenn B. Canner & Charles A. Luckett, *Developments in the Pricing of Credit Card Services*, 78 FED. RES. BULL. 652, 663 (1992); Paul Calem & Loretta Mester, *Consumer Behavior and the Stickiness of Credit card Interest Rates*, 85 FED. RES. BULLETIN 333 (1988); see also Darryl E. Getter, *Consumer Credit Risk and Pricing*, 40 J. CONSUMER AFFAIRS 41, 57-60 (2006); Sha Yang, Livia Markoczy, & Min Qi, *Unrealistic Optimism in Consumer Credit Card Adoption*, 28 J. ECON. PSYCH. 170, 177 (2007).

⁶⁷ See Brown & Plache, *supra* note **Error! Bookmark not defined.**, at 79-80.

⁶⁸ Brown & Plache, *supra* note **Error! Bookmark not defined.**; Howard Beales & Lacey L. Plache, *Rationality, Revolving, and Rewards: An Analysis of Revolving Behavior on New Credit Cards*, Working Paper (April 2007).

⁶⁹ Darryl E. Getter, *The Credit Card Market: Recent Trends, Funding Cost Issues, and Repricing Practices*, CRS REPORT FOR CONGRESS 2-3 (Feb. 27, 2008).

⁷⁰ See Zywicki, *Economics of Credit Cards*, *supra* note **Error! Bookmark not defined.**, at 107-08.

credit card contracts, such as the grace period for payment, benefits such as frequent flier miles, and whether there is an annual fee, just as standard economic theory would predict.⁷¹

There also is no evidence that borrowers systematically underestimate their likelihood of credit card borrowing or the cost of it.⁷² Most consumers choose the credit card plan that is most suitable for their needs and those who do not tend to learn fairly rapidly from their mistakes and switch to a more appropriate card, with those who made the biggest mistakes being the ones most likely to switch.⁷³ In fact, with respect to credit cards empirical research indicates that where consumers err, they do so by *overestimating* their likelihood of revolving rather than underestimating.⁷⁴ Consumers are less likely to revolve on higher-APR credit cards and are more likely to revolve where they pay an annual fee in exchange for a lower interest rate.⁷⁵ Those who pay no annual fee are the least likely to revolve balances, indicating that consumers are not stockpiling credit cards on which they are later induced to resolve balances.⁷⁶ When a consumer obtains a new credit card, the primary predictor of whether she will revolve on that card is whether she

⁷¹ Durkin, *supra* note 65, at A112; Canner & Luckett, *supra* note 66.

⁷² Canner & Luckett, *supra* note 66, at 665; Cargill & Wendel, *supra* note **Error! Bookmark not defined.**, at 386.

⁷³ See Brown & Plache, *supra* note **Error! Bookmark not defined.**; Sumit Agarwal, Souphala Chomsisengphet, Chunlin Liu, & Nicholas S. Souleles, *Do Consumers Choose the Right Credit Contracts?*, Fed. Res. Bank of Chicago Working Paper WP 2006-22 (Oct. 23, 2006); Sumit Agarwal, John C. Driscoll, Xavier Gabaix, & David Laibson, *Stimulus and Response. The Path from Naivete to Sophistication in the Credit Card Market*, Working Paper (Aug. 20, 2006). This “learning” phenomenon has been observed with other consumer contracts as well. See Eugenio Miravete & Ignacio Palacios-Huerta, *Rational Attention in a Repeated Decision Problem*, Working Paper (Sept. 2004).

⁷⁴ Agarwal, et al., find that consumers rarely erred in choosing the no-annual fee, higher interest rate cards, correctly predicting that they would not revolve. Instead, they disproportionately erred in choosing the high-fee, low-interest rate card, and then failing to revolve enough debt to justify the payment of the annual fee. Agarwal, et al., *Do Consumers Choose*, *supra* note 73, at 8-12. One study that purports to find an “unrealistic optimism” bias in credit card borrowing did not try to determine whether there is also unrealistic pessimism or the relative frequency of optimism and pessimism bias. See Yang, et al., *supra* note 66.

⁷⁵ Beales & Plache, *supra* note 68.

⁷⁶ Beales & Plache, *supra* note 68.

revolved on the old card, suggesting that getting a new credit card does fundamentally change consumer behavior or “seduce” consumers into revolving. Moreover, a cardholder becomes *less* likely to revolve balances the longer they hold their card. In addition, consumers who hold rewards cards are less likely to revolve than those who do not, thereby suggesting that the promise of these rewards does not induce a borrower to short-sightedly “overconsume” and thereby unconsciously pile up debt.



3105 Tydings Hall
College Park, Maryland 20742-7211

Professor Lawrence M. Ausubel

TESTIMONY

**BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
OF THE UNITED STATES SENATE**

**HEARING ON
“MODERNIZING CONSUMER PROTECTION
IN THE FINANCIAL REGULATORY SYSTEM:
STRENGTHENING CREDIT CARD PROTECTIONS”**

FEBRUARY 12, 2009

**BY
LAWRENCE M. AUSUBEL
PROFESSOR OF ECONOMICS
UNIVERSITY OF MARYLAND**

Good morning, Chairman Dodd, Ranking Member Shelby, and members of the Committee, and thank you for inviting me here. My name is Lawrence Ausubel, and I am a Professor of Economics at the University of Maryland.

One of the main issues we are discussing today concerns what consumer advocates call “penalty interest rates,” but the industry refers to as “risk-based pricing.” Consumer advocates assert that when the typical issuer raises the credit card interest rate by 12 to 15% following a late payment, this is penalty pricing intended to take revenues from their most vulnerable customers. However, industry representatives respond that consumers who miss payments are the most likely to eventually default, and all they are doing is requiring the riskiest consumers to shoulder their true cost.

As the author of the most-cited article on credit cards in the economics literature, I have been eager to determine which characterization is more accurate. The consumer view would justify legislation such as the Dodd bill; while the industry view would suggest that such rules are misplaced. Unfortunately, the data necessary to answer this question is typically kept confidential within the confines of the largest issuers. However, the industry recently produced a report which, I suspect inadvertently, enables the researcher to obtain answers which are nearly definitive.

In October 2008, Morrison & Foerster LLP issued a data study in response to the then-proposed rulemaking by the Federal Reserve Board to amend Regulation Z with respect to credit cards. Their data study purports to collect proprietary account-level data representing 70% of the credit-card industry’s outstanding balances. It considers various delinquency events, for example, going 16–30 days past due, or going 3-or-more-days past due on two separate occasions; and it reports the percentage of these consumers who ultimately go 90 days past due or bankrupt. Using their reported numbers, I was able to perform simple back-of-the-envelope calculations that enable me to reach the conclusion that the increases in interest rates bear no reasonable relation to default risk, i.e. these are penalty interest rates that demand regulation.

Two Sample Calculations

First, consider the May 2006 cohort of accounts in the Morrison & Foerster study.¹ 9.3% of the accounts that were current in May 2006 went 90 days past due or bankrupt in the following 22 months. By comparison, 20.7% of the accounts that were 16–30 days late in May 2006 went 90 days past due or bankrupt in the same period. Converting these loss rates into annual rates² of net credit losses,³ we find that the increased probability of loss per year is:

$$(12 / 22) \times (20.7\% - 11.3\%) / 1.39 = 4.47\%$$

An overly literal interpretation of risk-based pricing (but see below) would say that these consumers merited an increase in their interest rate of 4.47%. By way of contrast, the standard repricing in the market today is a 12% to 15% increase in interest rate. By any standard, these are penalties, not risk-based pricing.

Second, consider the April 2007 cohort of accounts. 4.5% of the accounts that were current in April 2007 went 90 days past due or bankrupt in the following 11 months. By comparison, 11.5% of the accounts that were 3-or-more-days past due on two separate occasions subsequently went 90 days past due or bankrupt in the same period. Converting these loss rates into annual rates⁴ of net credit losses,⁵ we find that the increased probability of loss per year is:

$$(12 / 11) \times (11.5\% - 4.5\%) / 1.39 = 5.5\%$$

An overly literal interpretation of risk-based pricing (again see below) would say that these consumers merited an increase in their interest rate of 5.5%. By way of contrast, the standard

¹ See the Oct. 3, 2008 letter / data study of Morrison & Foerster LLP (2008), Exhibit 1, Table 1b, p. 10 of pdf.

² Converting this into an annual rate requires multiplying by (12/22).

³ First, according to footnote 2 of the Aug. 7, 2008 Morrison & Foerster Data Study, only 80% of these accounts “will be charged off or go bankrupt.” Second, of those accounts that are charged off or go bankrupt, the contemporaneous rate of recovery (expressed as a net present value) was about 10%. Consequently, going from “90 days past due or bankrupt” to “economic losses” requires dividing by a factor of: $1 / [0.8 \times (1 - 0.1)] = 1.39$.

⁴ Converting this into an annual rate requires multiplying by (12/11).

⁵ See footnote 3.

repricing in the market today is a 12% to 15% increase in interest rate. By any standard, these are penalties, not risk-based pricing.

What we have just seen quite clearly is that the penalties imposed on consumers are at least double or triple the enhanced credit losses attributable to these consumers. Moreover, the calculations that I have just outlined are overly generous to the industry, in several respects:

- (1) To be more than fair, I selected 16–30 days late as my selection criterion. Many banks use a short trigger, and using a shorter trigger such as 5 days late would obviously produce more lopsided and egregious results.
- (2) My calculations ignored late fees, which are typically \$39 today and with availability of data would clearly be included. Inclusion of late fees would obviously produce more lopsided and egregious results.
- (3) It is unclear whether Morrison & Foerster is using the relevant selection criterion. Morrison & Foerster looks at “account 16–30 days late.” One can argue reasonably persuasively that it would be more relevant to condition on “account 16–30 days late but account becomes current before day 31.” After all, if the cardholder fails to become current before day 31, the lender would still be able to increase the rate under a 30-day rule. Since becoming current is good news, this must imply lower loss rates.

At the end of the day, the economic conclusion is inescapable that these are penalty interest rates, based not on the cost to the banks but on demand factors. Observe that the demand of consumers who face penalty rates is rather inelastic; they are often borrowed up, distressed, and have diminished alternative borrowing opportunities. Thus, setting penalties according to demand factors means charging what the market will bear—which, in the absence of regulation, apparently is a 12 to 15% penalty, applied retroactively.

Current Economic Crisis

It is important to emphasize that a retroactive, penalty rate increase for distressed consumers is precisely the opposite policy prescription that we apply in other areas of lending. For example, there is a growing consensus today that, in the mortgage area, loan modifications are needed (i.e. reductions in principal and/or the interest rate). Why do credit card issuers unilaterally adjust interest rates upward, when lenders as a group might benefit from downward adjustment? This occurs because credit-card lenders face a common-pool problem, a prisoner's dilemma problem. While lower interest rates by the group of lenders would reduce the likelihood of bankruptcy and increase eventual collections, each lender individually has the incentive to grab as much money as possible prior to bankruptcy. Professor Amanda Dawsey, of the University of Montana, and I have research showing that a consumer with debts of \$5,000 to each of four lenders is more likely to default than a consumer with a debt of \$20,000 to a single lender. The current legality of "universal default" and "any time, any reason" clauses exacerbates the prisoner's dilemma problem.

In short, economic analysis of recent data supports stricter regulation of the credit card industry, particularly with respect to penalty interest rates imposed on existing balances. The Fed has taken some action in this area but, regrettably, the effective date of the new regulations is July 1, 2010. The current economic crisis makes it all the more urgent that Congress adopt the Dodd bill sooner.

References

- Ausubel, Lawrence M., "The Failure of Competition in the Credit Card Market," *American Economic Review*, 81, No. 1, March 1991, 50-81.
- Ausubel, Lawrence M. and Amanda E. Dawsey, "Penalty Interest Rates, Universal Default, and the Common Pool Problem of Credit Card Debt," Mimeo, University of Maryland and University of Montana, March 2008.
- Dawsey, Amanda E., "Externalities among Creditors and Personal Bankruptcy," Mimeo, University of Montana, November 2007.
- Morrison & Foerster LLP, "Data Study" (Letters dated August 7 and October 3, 2008 from Oliver I. Ireland to the Federal Reserve Board, with data attachments).

Penalty Interest Rates, Universal Default, and the Common Pool Problem of Credit Card Debt

Lawrence M. Ausubel and Amanda E. Dawsey*

March 2008

Preliminary and Incomplete

1 Introduction

It is now reasonably well understood that unsecured credit such as credit card debt poses a common-pool problem. Since it is not secured by any collateral and since recoveries will be allocated pro rata under bankruptcy, each credit card issuer is motivated to try to collect from the “common pool” — and the attempt to collect by one issuer may pose a negative externality to other issuers. When a consumer becomes financially distressed, each credit card lender has an incentive to try to become the first to collect. For example, a lender may engage in aggressive collection efforts even if they may result in the consumer seeking protection under bankruptcy law: the benefits of collection accrue to this lender alone, while the consequences of a bankruptcy filing are distributed over all credit card lenders and other creditors.

This paper attempts to explore the recent proliferation of penalty interest rates and universal default clauses in credit card contracts. By a *penalty interest rate*, we mean the following: The fairly standard credit card offering in 2008 includes an introductory interest rate on new purchases of 0% for the first several billing periods, followed by a post-introductory interest rate on new purchases of 9.99% to 15.99%. However, if payment is received late once during the introductory period, the interest rate reverts to the post-introductory APR; and if payment is received late twice within any 12 billing periods, the interest rate reverts to a “default APR” of typically 23.9% to 29.99%. In addition to the increase in interest rate, the cardholder generally is also assessed a late payment fee of typically \$39.

By a *universal default* clause, we mean the following: Many credit card contracts provide that the penalty interest rate is triggered by late payments to this credit card issuer, but it may also be triggered by late payments to other creditors. Depending on the issuer’s particular practices, universal default may also be triggered by deterioration in the consumer’s FICO score,

* Department of Economics, University of Maryland, College Park, MD 20742, and Department of Economics, University of Montana, Missoula, MT 59812. We gratefully acknowledge the research assistance of Oleg Baranov, and helpful comments by Richard Hynes and Thayer Morrill.

Copyright © 2008 by Lawrence M. Ausubel and Amanda E. Dawsey. All rights reserved.

exceeding a credit limit, utilizing a credit line beyond a particular percentage, or more generally, “based on information in your credit report.”¹

An issuer can accomplish the same effect (and more) with an “*any time, any reason*” repricing clause. An example of the relevant language is: “Account and Agreement terms are not guaranteed for any period of time; all terms, including the APRs and fees, may change in accordance with the Agreement and applicable law. We may change them based on information in your credit report, market conditions, business strategies, or for any reason.”² Bills recently introduced in the U.S. Congress propose to regulate penalty interest rates, universal default clauses, and “any time, any reason” repricing.³

A useful explanation and interpretation of penalty interest rates and universal default clauses in credit card contracts is that each issuer is seeking to maximize its own individual claim on the common pool of unsecured debt of a financially-troubled consumer. To the extent that the consumer repays any debt, a high penalty rate (such as 29.99%) provides incentives for the credit-card issuer to be repaid before other lenders. And to the extent that the consumer fails to repay the debt, the high penalty rate increases the issuer’s nominal loan balance and therefore the issuer’s pro-rata share of recoveries following bankruptcy. Since every credit-card issuer has this unilateral incentive to charge a high penalty rate and to impose a severe universal default clause, the likely outcome in the absence of threatened or actual regulation is inefficiently-high penalty rates together with inefficiently-broad and unforgiving universal default clauses. As such, the common-pool problem of unsecured debt may be viewed as a market failure, yielding possible scope for government intervention in useful ways.

2 Related Literature

The premise of an externality imposed by competing creditors is related to the idea of sequential banking studied by Bizer and DeMarzo (1992). The difference here is that the externality in our model results from competition to collect from a defaulting borrower, rather than as a consequence of an increase in risk as the borrower acquires additional loans. The idea that creditors have an incentive to grab payment from borrowers, even when doing so hurts the borrower’s ability to repay her total debt, is one of the fundamental principles underlying much of the US bankruptcy system.⁴ Thomas H. Jackson, along with Douglas Baird and Robert Scott, has formalized this idea in a series of articles using economic models to examine the effects of these externalities.⁵ Under the Jackson regime, bankruptcy can actually increase the welfare of creditors

¹The particular language of “based on information in your credit report” is taken from the disclosure associated with a Bank of America online credit card offering. The associated URL, accessible on March 12, 2008, is: <https://www.applyonlinenow.com/USCCapp/Ctl/display?pageid=disclosure&cp=>.

²This language is taken from the same Bank of America disclosure as referenced in the previous footnote.

³See H.R. 5244 (“Credit Cardholders’ Bill of Rights Act of 2008”) and S. 1395 (“Stop Unfair Practices in Credit Cards Act of 2007”).

⁴See, for example, Tene (2003).

⁵See, for example, Jackson (1985 and 1986), Baird and Jackson (1990) and Jackson and Scott (1989).

by forestalling destructive creditor collection and mitigating the negative externality, and these savings are passed along to the borrower in the form of lower interest rates.

Several authors have argued that Jackson's approach is overly theoretical and unsubstantiated by empirical evidence.⁶ In response to this criticism, Dawsey (2007) provides an empirical test. It shows that, holding debt level constant, increasing a borrower's number of creditors increases the probability a borrower files for bankruptcy and decreases the probability she chooses informal bankruptcy, defined as long-term default without a formal bankruptcy filing. These results lend support to Jackson's hypothesis that when a creditor attempts to collect from a distressed borrower, his efforts reduce the likelihood a borrower will repay her other loans and increase her probability of filing for bankruptcy.

A few papers have examined policy tools other than bankruptcy that may reduce the negative externality of competitive collections. Williams (1998) finds some evidence that credit counseling services, by facilitating coordination among lenders, decreases competitive collections efforts. Brunner and Krahnen (2004) observe that bank pools, a legal mechanism for allowing coordination among creditors in Germany, also decrease destructive competition among creditors. Franks and Sussmen (2005) find that the British contractualist system mitigates the incentive of multiple lenders to prematurely liquidate a distressed firm.

Like Bizer and DeMarzo, the small group of papers examining the effects of "cross default" clauses have focused on the borrower's increased riskiness due to multiple loans. Like universal default clauses, cross default clauses specify that default on one loan results in default on all loans covered by the clause. Using comparative statistics, Childs et al (1996) find that cross default clauses in commercial mortgage contracts substantially reduce default risk. In the Childs model, cross default gives creditors access to additional collateral which yields diversification benefits, decreasing default frequency and severity. The Childs model differs from the one presented here in two important respects. First, the cross default clause gives the creditor access to additional collateral, which would not be a factor for the unsecured creditor in our model. Second, the Childs approach is to consider only cases involving a single creditor and borrower; the contention of this paper is that when the model is broadened to allow the borrower to interact with more than one creditor, any benefits of cross-default are mitigated by the negative externality it imposes.

Two purely theoretical papers find results that are similar to Childs'. Mohr and Thomas (1997) present a model in which a sovereign nation enters into both a loan contract and an environmental agreement, and a cross-default clause reduces the risk of default on either obligation. Mohr (1995) finds a similar result when a country is both in debt and involved in international environmental permit markets. These results are driven by the borrower's desire to avoid the double punishment that would result from defaulting on two contracts rather than only one. Again, these papers focus on borrower riskiness rather than externalities involved in collection.

⁶See Block-Lieb (1993) and Rothschild (2007).

3 The Model

A consumer wishes to consume over three periods. He earns income only in the second and third periods, and so has a consumption-smoothing motive to borrow on credit cards. More specifically, the consumer's utility is given by $U = \sum_{t=1}^3 \delta^{t-1} u(c_t)$, where $u(c_t) = c_t^\gamma$ ($\gamma < 1$),

$\delta = \frac{1}{1+r_m}$ denotes the discount factor between periods, c_t denotes the consumer's consumption in period t ($t = 1, 2, 3$), and r_m denotes the market interest rate. The consumer's income in period 1, denoted I_1 , equals zero. The consumer's income in periods 2 and 3, denoted I_2 and I_3 respectively, are drawn independently from uniform distributions on the interval $[0, \bar{I}]$. The consumer does not learn I_2 until period 2 and does not learn I_3 until period 3.

The consumer borrows on his credit card(s) in period 1 so as to maximize his expected utility. If the consumer chooses to consume c_1 in period 1, then he runs up a credit card balance of c_1 , which with application of an interest rate r becomes a balance of $(1+r)c_1$ in period 2. To simplify the solution of the model, the consumer is permitted to borrow on his credit card(s) only in period 1. In addition, if the consumer borrows from two cards in period 1, then it is assumed that he borrows equal amounts on each of the two cards, i.e. amounts of $\frac{1}{2}c_1$ each. In period 2, the consumer's actions are limited to repaying his credit card balances (in whole, in part, or not at all). Let ρ denote the fraction of his balances that he repays in period 2. If the consumer repays fraction ρ in period 2, that requires him to pay $\rho(1+r)c_1$, leaving him $c_2 = I_2 - \rho(1+r)c_1$ in consumption for period 2.

The interest rate applied to the consumer's credit card balances from period 2 to period 3 may be a regular interest rate r or a penalty interest rate r^p . With one credit card lender, the regular interest rate is applicable if the consumer meets a required minimum payment α , i.e. if $\rho \geq \alpha$. However, if the consumer does not meet the required minimum payment, i.e. if $\rho < \alpha$, then the penalty rate is applicable. With two credit card lenders, the rate depends on which (if any) lenders have received the required minimum payment, and on whether a universal default clause applies to the given credit card. These conditions are elaborated below.

In period 3, the terminal period, the consumer has no decision problem to solve. Instead, the consumer simply consumes out of his income (if any) net of debt repayment. Thus, if the consumer was subject to the regular interest rate from period 2 to period 3, then his consumption in period 3 is $c_3 = \max\{0, I_3 - (1+r)(1-\rho)(1+r)c_1\}$. However, if the consumer was subject to the penalty interest rate from period 2 to period 3, then his consumption in period 3 is $c_3 = \max\{0, I_3 - (1+r^p)(1-\rho)(1+r)c_1\}$. Note that the " $\max\{0, \cdot\}$ " terms in the previous expressions reflects that the credit card lender(s) cannot collect more than I_3 from the consumer; the money simply is not there to collect. Period 3 marks the end of the model. With two credit card lenders, their respective interest rates (including penalty rates, when triggered) are applied to their respective balances; and if the period 3 income is less than the balances owed, the income is applied pro rata between the two lenders.

There are n credit card issuers ($n \geq 3$) competing to lend to a consumer. A consumer is permitted to accept at most two credit cards at the stated terms. A credit card offer by issuer i consists of a pair of interest rates, (r_i, r_i^p) , where r_i is the regular interest rate and r_i^p is the penalty interest rate. Each of these values is chosen from the closed interval $[0, \bar{r}]$, where \bar{r} is the maximum interest rate that an issuer might select (e.g. a 29.99% APR). The other relevant terms of a credit card are its credit limit, \bar{L} , and its required minimum payment, α , in period 2. For simplicity, n , \bar{L} and α are constants that are exogenous to the model — and \bar{L} is specified so that the consumer wishes to borrow from two credit cards in period 1.

3.1 Own default

By *own default*, we refer to the contract term that a consumer is subject to a penalty interest rate on a credit card if he has not made the minimum repayment on that credit card. (By contrast, under universal default, the consumer is subject to the penalty rate if he has not made the minimum repayment on that credit card or on any other credit card. This case is treated in the next subsection.)

Under a rule of own default, there are three relevant possibilities:

- (1) The consumer makes at least the minimum payment on both cards. In that event, he is subject to the regular interest rate on both cards.
- (2) The consumer makes the minimum payment on card i but not on card j . In that event, he is subject to interest rate r_i on card i , but subject to interest rate r_j^p on card j .
- (3) The consumer does not make the minimum payment on either card. In that event, he is subject to interest rate r_i^p on card i and to interest rate r_j^p on card j .

In our preliminary results, it appears that an optimizing consumer will generally repay at least the minimum payment on a given card or else will repay zero (but will not repay an amount in between). Moreover, in the case where the consumer makes the minimum payment on only one card and the penalty rates on the two cards are different, the optimizing consumer will make the minimum payment on the card with the *higher* interest rate (i.e., it is advantageous for the consumer to repay high-interest debt before low-interest debt).

3.2 Universal default

Under universal default, the consumer is subject to the penalty rate if he has not made the minimum repayment on that credit card or on another credit card. Under a rule of universal default, there are three relevant possibilities:

- (1) The consumer makes at least the minimum payment on both cards. In that event, he is subject to the regular interest rate on both cards.
- (2) The consumer makes the minimum payment on card i but not on card j . In that event, he is subject to interest rate r_i^p on card i and to interest rate r_j^p on card j .

- (3) The consumer does not make the minimum payment on either card. In that event, he is again subject to interest rate r_i^p on card i and to interest rate r_j^p on card j .

Repaying one card but not the other does not avert any penalty interest rates at all. In our preliminary results, and for parameter values in the relevant range, it appears that an optimizing consumer will generally repay at least the minimum payment on both cards or else will repay zero on both cards (but will not repay one card, under universal default, or repay an amount in between).

4 Tentative General Results

RESULT 1. *It is never an equilibrium for the penalty rate to equal the regular rate.*

REASONING. Suppose not. Since missing a minimum payment signifies that the consumer received a low realization of income, the firm's expected profits conditional on a consumer missing a minimum payment to either firm is negative. If the firm unilaterally raises its penalty interest rate by ε , then to the extent that it induces early repayment, it is therefore profitable. And, to the extent that raising the penalty interest rate by ε does not induce early repayment, it simply yields higher revenues. ■

RESULT 2. *Symmetric equilibria under "own default" satisfy one of the following conditions:*

- (a) *The penalty interest rate \leq the maximum allowable interest rate, and the firm is indifferent between being repaid in period 2 and not being repaid in period 2.*
- (b) *The penalty interest rate = the maximum allowable interest rate, and the firm strictly prefers being repaid in period 2 to not being repaid in period 2.*

REASONING. Consider all possible penalty rates in the interval from the regular interest rate to the maximum allowable interest rate. By the same reasoning as for Result 1, at the regular interest rate, default results in negative expected profits, and therefore the firm strictly prefers being repaid in period 2 to not being repaid in period 2. Suppose that the firm also strictly prefers being repaid in period 2 to not being repaid in period 2 at all higher interest rates in the interval (where the associated regular interest rate has been chosen to be the equilibrium interest rate). Then either firm would profitably deviate by raising its penalty rate by ε whenever possible, making the maximum allowable interest rate the unique equilibrium penalty interest rate (Case (b)). Conversely, suppose that there exists a penalty interest rate in this interval such that the firm does not strictly prefer being repaid in period 2 (where the associated regular interest rate has been chosen to be the equilibrium interest rate). Then, let r^p denote the lowest such penalty interest rate. Then with a penalty interest rate of r^p (and the associated regular interest rate chosen to be the regular interest rate), a continuity argument implies that the firm is indifferent between being repaid in period 2 and not being repaid in period 2 (Case (a)). ■

5 Preliminary Results from Simulations

Our preliminary simulations are done with the following parameter values:

- $\gamma = 0.5$ (parameter in utility function)
- $\bar{I} = 1$ (income is distributed on interval $[0, 1]$)
- $\bar{L} = 0.2$ (credit limit on a given card)
- $\alpha = 0.2$ (minimum payment as percentage of balance)
- $r_m = 8\%$ (market interest rate)
- $\bar{r} = 30\%$ (maximum allowable penalty interest rate)

Repaying one card but not the other does not avert any penalty interest rates at all. In our preliminary results, it appears that an optimizing consumer will generally repay at least the minimum payment on both cards or else will repay zero on both cards (but will not repay one card, under universal default, or repay an amount in between).

5.1 Simulations under own default

Under own default, a candidate equilibrium in which the penalty interest rate equals the maximum allowable interest rate (Case (b) in Result 2) can first be simulated. In the simulation, we find that:

- $r = 12.60\%$ (regular interest rate)
- $r^P = 30\%$ (penalty interest rate)
- $P_2 = 54.67\%$ (probability of full repayment after missing payments on 2 cards)
- $P_1 = 61.67\%$ (probability of full repayment after missing payments on 1 card)
- $EU = 147.47$ (expected utility over all states of the world $\times 100$)

However, the candidate equilibrium of Case (b) is not a true equilibrium, for the following reason. The high penalty interest rate more than offsets the expected default losses (as a percentage of balances loaned). The firm strictly prefers *not* to be repaid in period 2 over being repaid in period 2. Thus, the firm could profitably deviate by offering a slightly lower penalty interest rate.

An interior solution, i.e., a candidate equilibrium in which the penalty interest rate is less than the maximum allowable interest rate (Case (a) in Result 2) can also be simulated. In the simulation, we find that:

- $r = 14.11\%$ (regular interest rate)
- $r^P = 18.89\%$ (penalty interest rate)
- $P_2 = 57.40\%$ (probability of full repayment after missing payments on 2 cards)
- $P_1 = 62.40\%$ (probability of full repayment after missing payments on 1 card)
- $EU = 147.56$ (expected utility over all states of the world $\times 100$)

The candidate equilibrium of Case (a) appears to be a true equilibrium. The penalty interest rate reflects the expected default losses (as a percentage of balances loaned), making the firm

indifferent between being repaid in period 2 and not being repaid in period 2. This is the requirement for equilibrium in this situation.

It is illuminating to see the consumer's debt level after period 2 (and implied repayment in period 2). This is graphed in the first panel of Figure 1. At low levels of income realization, the consumer misses the minimum payment on both cards. At the next interval of income realizations, the consumer makes the minimum payment on one card but no payment on the other. At the next interval of income realizations, the consumer makes the minimum payment on both cards, but no additional repayment. Finally, at the highest income realizations, the consumer's repayment increases in income, until full repayment occurs.

5.2 Simulations under universal default

Under universal default, a candidate equilibrium in which the penalty interest rate equals the maximum allowable interest rate (Case (b) in Result 2) can be simulated using the same parameter values. In the simulation, we find that:

$$\begin{aligned} r &= 12.79\% \text{ (regular interest rate)} \\ r^p &= 30\% \text{ (penalty interest rate)} \\ P_2 &= 54.80\% \text{ (probability of full repayment after missing payments on 2 cards)} \\ P_1 &: \text{not applicable (prob. of full repayment after missing payments on 1 card)} \\ EU &= 147.43 \text{ (expected utility over all states of the world} \times 100) \end{aligned}$$

The candidate equilibrium of Case (b) appears to be a true equilibrium. The high penalty interest rate more than offsets the expected default losses, and the firm strictly prefers *not* to be repaid in period 2 over being repaid in period 2. However, under universal default, this does not imply that either firm has a profitable deviation. The explanation appears to be that the consumer generally does not make a minimum payment on a single card under universal default, as the consumer would still be subject to penalty interest rates on both cards. Therefore, a modest reduction on a firm's penalty interest rate has negligible effect on the probability of repayment — but serves to reduce the firm's revenues.

It is illuminating to see the consumer's debt level after period 2 (and implied repayment in period 2). This is graphed in the second panel of Figure 1. At low levels of income realization, the consumer misses the minimum payment on both cards. There is *no* interval where the consumer makes the minimum payment on one card but no payment on the other. At the next interval of income realizations, the consumer makes the minimum payment on both cards, but no additional repayment. Finally, at the highest income realizations, the consumer's repayment increases in income, until full repayment occurs.

6 Discussion

Subject to the caveat that our results are only preliminary, let us compare the regimes of own default and universal default simulated in the previous section and make some observations. First, the penalty interest rate appears to be higher under universal default, and the higher interest

rate exceeds the enhanced credit risk associated with missing a payment. Second, the probability of full repayment following missing the minimum payment is lower under universal default, i.e., universal default clauses tend to increase the difficulty for consumers to emerge from debt without serious defaults or bankruptcy. Third, the expected utility of consumers over all states of the world appears to be lower in the equilibrium that we have constructed under universal default, as compared to under own default. Finally, since the firms' expected profits have been held constant in this exercise, it can also be said that social welfare is expected to be lower under universal default than under own default. In short, the simulations appear to favor limitations on the practice of universal default.

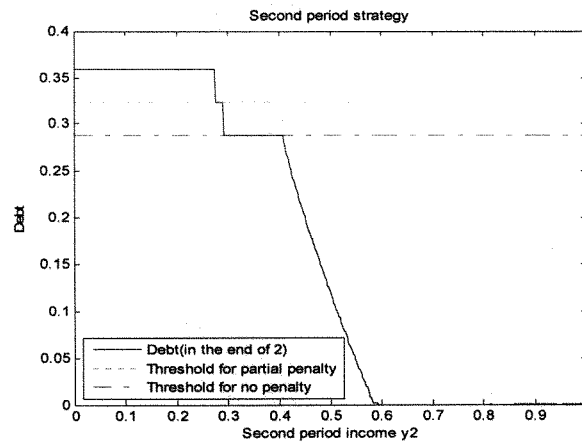
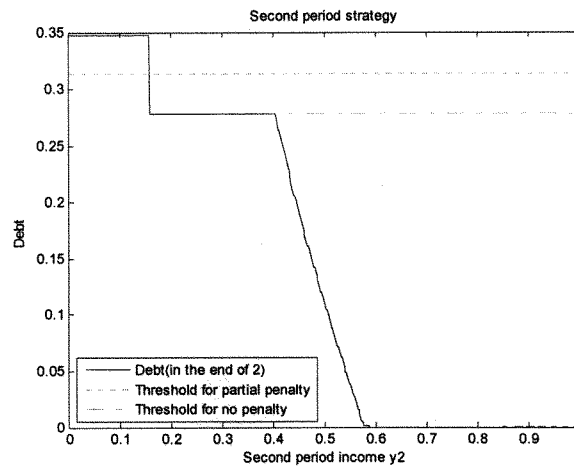
Our confidence in these results needs to be tempered by their preliminary nature and by the possibility that there are other parameter values for which these results may be reversed. Still, there appears to be present a tight argument why lenders would impose universal default clauses, but society as a whole (including lenders) would benefit from a collective choice to eliminate them.

The analysis in this paper may be limited in that consumers have been assumed to make fully-optimizing decisions (subject to their uncertain future incomes). However, there exists longstanding evidence that consumers may tend to underestimate their future borrowing (see, for example, Ausubel, 1991) or otherwise be overly optimistic about their future financial prospects. Under such scenarios, consumers would likely take insufficient account of the penalty interest rates that they might face. As such, the effects and conclusions described in this paper would likely be amplified.

References

- Ausubel, Lawrence M., "The Failure of Competition in the Credit Card Market," *American Economic Review*, 81, No. 1, March 1991, 50-81.
- Baird, Douglas G. and Thomas H. Jackson, *Cases, Problems and Materials on Bankruptcy*. Foundation Press, 2001.
- Bizer, David S. and Peter M. DeMarzo, "Sequential Banking," *Journal of Political Economy*, 100 (1992): 41-62.
- Block-Leib, Susan, "Fishing in Muddy Waters: Clarifying the Common Pool Analogy as Applied to the Standard for Commencement of a Bankruptcy Case," *American University Law Review*, 42 (1993): 337-431.
- Brunner, Antje and Jan Pieter Krahn, "Multiple Lenders and Corporate Distress: Evidence on Debt Restructuring," C.E.P.R. Discussion Paper 4287 (2004).
- Childs, Paul D., Steven H. Ott, and Timothy J. Riddiough, "The Value of Recourse and Cross-Default Clauses in Commercial Mortgage Contracting," *Journal of Banking and Finance*, 20 (1996): 511-536.
- Dawsey, Amanda, "Externalities among Creditors and Personal Bankruptcy," Mimeo, University of Montana, November 2007.
- Franks, Julian and Oren Sussman, "Financial Distress and Bank Restructuring of Small to Medium Size UK Companies," *Review of Finance*, 9 (March 2005): 65-96.
- Jackson, Thomas H., "Translating Assets and Liabilities to the Bankruptcy Forum," *Journal of Legal Studies*, 14, 73, 74-77 (1985).
- Jackson, Thomas H., *The Logic and Limits of Bankruptcy Law*, Cambridge, Massachusetts: Harvard University Press, 1986.

- Jackson, Thomas H. and Robert E. Scott, "On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain." *Virginia Law Review*, 75, 155, 178 (1989).
- Mohr, Ernst, "International Environmental Permit Trade and Debt: The Consequences of Country Sovereignty and Cross-Default Policies." *Review of International Economics*, 3 (1995): 1-19.
- Mohr, Ernst and Jonathon P. Thomas, "Pooling Sovereign Risk: The Case of Environmental Treaties and International Debt." *Journal of Development Economics*, 55 (1998): 173-190.
- Rothschild, Brian, "The Illogic of No Limits on Bankruptcy." 23 *Bank. Dev. J.* 473 (2007).
- Tene, Omer, "Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Organizations." 19 *Bank. Dev. J.* 287 (2004).
- Williams, Winton, *Games Creditors Play: Collecting from Overextended Consumers*, Durham, North Carolina: Carolina Academic Press, 1998.

Figure 1: Consumer Debt in Simulations**Simulation under “Own Default”****Simulation under “Universal Default”**



**Consumers
Union**

consumer action
Education and advocacy since 1974



U.S. PIRG
Federation of
State PIRGs

TESTIMONY OF
TRAVIS B. PLUNKETT,
LEGISLATIVE DIRECTOR

ON BEHALF OF
THE CONSUMER FEDERATION OF AMERICA, CENTER FOR
RESPONSIBLE LENDING, CONSUMER ACTION, CONSUMERS UNION,
NATIONAL CONSUMER LAW CENTER (ON BEHALF OF ITS LOW-INCOME
CLIENTS) AND U.S. PIRG

BEFORE THE
BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE
OF THE
UNITED STATES SENATE

REGARDING
MODERNIZING CONSUMER PROTECTION IN THE FINANCIAL REGULATORY
SYSTEM: STRENGTHENING CREDIT CARD PROTECTIONS

FEBRUARY 12, 2009

Chairman Dodd, Ranking Member Shelby and members of the Committee, my name is Travis Plunkett and I am the legislative director of the Consumer Federation of America (CFA).¹ I am testifying today on behalf of CFA, the Center for Responsible Lending,² Consumer Action,³ Consumers Union, the publisher of Consumer Reports,⁴ the National Consumer Law Center,⁵ on behalf of its low-income clients, and U.S. PIRG.⁶ I appreciate the opportunity to offer our comments on the harmful effects on consumers of some current credit card industry practices, as well as our recommendations on how the Senate can strengthen protections for consumers. Such

¹ The **Consumer Federation of America** is a nonprofit association of over 280 pro-consumer groups, with a combined membership of 50 million people. CFA was founded in 1968 to advance consumers' interests through advocacy and education.

² The **Center for Responsible Lending** (CRL) is a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help, which consists of a credit union and a non-profit loan fund focused on creating ownership opportunities for low-wealth families, primarily through financing home loans to low-income and minority families who otherwise might not have been able to purchase homes. Self-Help has provided over \$5 billion in financing to more than 60,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across the United States. Another affiliate, Self-Help Credit Union, offers a full range of retail products, and services over 3,500 checking accounts and approximately 20,000 other deposit accounts, and recently inaugurated a credit card program.

³ **Consumer Action**, founded in 1971, is a San Francisco based nonprofit education and advocacy organization with offices in Los Angeles and Washington, DC. For more than two decades, Consumer Action has conducted a survey of credit card rates and charges to track trends in the industry and assist consumers in comparing cards.

⁴ **Consumers Union** is a nonprofit membership organization chartered in 1936 under the laws of the state of New York to provide consumers with information, education and counsel about good, services, health and personal finance, and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of Consumer Reports, its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, Consumer Reports with more than 5 million paid circulation, regularly, carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

⁵ The **National Consumer Law Center, Inc. (NCLC)** is a non-profit corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes and regularly updates a series of sixteen practice treatises and annual supplements on consumer credit laws, including Truth In Lending, Cost of Credit, Consumer Banking and Payments Law, Foreclosures, and Consumer Bankruptcy Law and Practice, as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low income people, conducted training for tens of thousands of legal services and private attorneys on the law and litigation strategies to deal predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of the all federal laws affecting consumer credit since the 1970s, and regularly provide comprehensive comments to the federal agencies on the regulations under these laws.

⁶ The **U.S. Public Interest Research Group** is the national lobbying office for state PIRGs, which are non-profit, non-partisan consumer advocacy groups with half a million citizen members around the country.

action is more urgent than ever because taxpayers are now propping up major national credit card issuers through several enormously expensive government programs. If the government is going to invest in the credit card industry and attempt to spur the extension of credit, it is essential that it ensure that the loans that this industry is offering to Americans are fair and sustainable.

We applaud the Committee for examining many questionable practices in the credit card industry, including the terms and conditions of credit card contracts, unjustified fees and interest rates and marketing and credit extension practices. It is obviously very important in the midst of a serious economic recession that Congress act fast to rein in these abusive practices. Despite the fact that credit card lenders have recently cut back on the amount of new credit they offer and started reducing credit lines for some borrowers, years of aggressive and irresponsible lending have helped put borrowers in a very vulnerable financial position. More Americans are now late or in default on their loans than at any time since the recession of 2001 and 2002. Based on the loss trends that major card issuers are reporting, it is quite possible that 2009 will be one of the worst years on record for credit card consumers.

For fifteen years, CFA and many others have warned that credit card issuers were irresponsibly pushing cardholders to take on more debt than they could afford, and then using unfair and deceptive tactics to increase debt loads and issuer profits. The Credit Card Accountability, Responsibility and Disclosure (CARD) Act, introduced by Chairman Dodd and a number of co-sponsors, is a comprehensive proposal that will end the most arbitrary, abusive, and unfair credit card lending practices that trap consumers in an unsustainable cycle of costly

debt, such as sharply escalating “universal default” interest rates that can double some cardholders’ interest rates or monthly payments overnight. The Credit CARD Act also targets a number of damaging practices not addressed by federal banking regulators in their recent credit card rule, such as the irresponsible extension of credit to young consumers with little income, and exceedingly high penalty fees charged for minor cardholder mistakes.

These tricks and traps have always been unfair, but now, at a time of economic crisis when consumers can least afford it, they produce devastating financial repercussions. Moderate-income families with little flexibility in their budgets, or those who have experienced a serious loss in income, are particularly hard hit if they have to pay more in unjustifiable fees and credit card interest. The meltdown of the sub-prime mortgage market demonstrates the importance of ending abusive lending practices when warning signs arise. Congress should take steps now to rein in these practices to forestall an even greater economic crisis.

A. CARDHOLDERS ARE SHOWING SERIOUS SIGNS OF ECONOMIC STRESS

As the economy has worsened and home foreclosures have increased to record levels, consumers are increasingly having serious difficulty paying their credit card bills. One widely watched measure of financial health, the amount of credit card debt paid off by Americans monthly, is now at one of the lowest levels ever recorded.⁷ Credit card charge-offs, the percentage of the value of credit card loans removed from the books (net of recoveries), or “written off,” have been persistently high for most of the last thirteen years and are now

⁷ Chu, Kathy, “November Credit-Card Payoff Rate Fell Sharply,” *USA Today*, February 8, 2009. The monthly payment rate fell by 2.5 percentage points to 16.1 percent in November 2008, according to CardTrak.com.

approaching the highest levels on record. During the decade between the end of 1995 and the start of 2006, credit card charge-offs were not below 4 percent in a single quarter.⁸ They increased to more than 4 percent in the fourth quarter of 2006 and broke 4 percent again during the later half of 2007. Since then, charge-offs have escalated sharply to 5.62 percent in the third quarter of 2008. There is a very good chance that charge-offs will keep rising because the number of delinquent credit card payments – an early sign of payment difficulty – are also approaching historically high levels. Thirty-day credit card delinquencies are now at their highest point in six years, since the last economic recession ended.⁹ Moreover, a number of major issuers have reported fourth quarter charge-offs that indicate that borrower defaults and issuer losses will exceed those of the last two recessions.¹⁰ The difficulty that many families are having affording their credit card bills has been exacerbated by the mortgage crisis. As home values have dropped sharply, Americans have been unable to use home equity loans and home refinancing to pay off their credit card debts.¹¹ Moreover, despite rising credit card delinquencies, there is evidence that some families are attempting to stay current on their credit card loans but not their mortgage payments, a shift in behavior from past economic crises.¹²

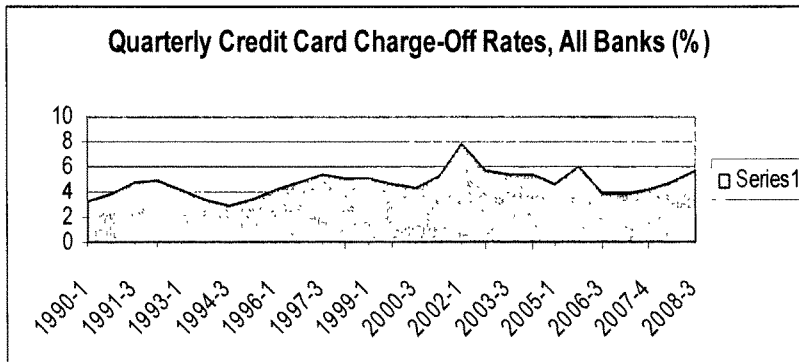
⁸ Federal Reserve Board, "Charge-Off and Delinquency Rates on Loans and Leases at All Commercial Banks," available at www.federalreserve.gov/release/chargeoff. Most experts attribute lower charge-offs in 2006 to the surge of bankruptcy filings (and corresponding increase in charge-offs) that occurred in the third and fourth quarters of 2005.

⁹ 30-day credit card delinquencies during first three quarters of 2008 were between 4.79 and 4.88 percent, the highest levels since 2002. Federal Reserve Board, "Charge-Off and Delinquency Rates on Loans and Leases at 100 Largest Commercial Banks" "U.S. Credit Card Delinquencies at Record Highs – Fitch," *Reuters*, February 4, 2009.

¹⁰ Terris, Harry, "Credit Card Losses Seen Surpassing Levels of Last Two Recessions," *American Banker*, January 28, 2009.

¹¹ Westrich, Tim and Weller, Christian E., "House of Cards, Consumers Turn to Credit Cards Amid the Mortgage Crisis, Delaying Inevitable Defaults," Center for American Progress, February 2008.

¹² Chu, Kathy, "More Americans Using Credit Cards to Stay Afloat," *USA Today*, February 28, 2008.

Quarterly Credit Card Charge-Off Rates, All Banks (%)¹³

Although some issuers have suffered losses in the last year, over time the credit card industry has been the most profitable in the banking sector, earning a return on assets (ROA) from 1995 to 2008 that was more than three times greater than that for commercial banks overall.¹⁴ Because of the high mortgage losses that many large banks experienced in 2007, there was more than a five-fold difference between bank and credit card profits.¹⁵

¹³ Federal Reserve Board, "Charge-Off and Delinquency Rates on Loans and Leases at All Commercial Banks," available at www.federalreserve.gov/releases/chargeoff/chgallsa.htm, accessed April 14, 2008.

¹⁴ "Card Profits 04," *CardTrak*, January 24, 2005; "Banner Year," *CardTrak*, February 2004; FDIC, *FDIC Quarterly Banking Profile*, Third Quarter 2006 at 5, Table I-A; FDIC, *FDIC Quarterly Banking Profile*, Fourth Quarter 2000 at 4, Table I-A. Commercial banks' average return on assets between 1995 and 2004 was 1.23 percent, less than one third the size of the credit card industry average return on assets of 3.73 percent over the same period, according to R.K. Hammer and Associates.

¹⁵ ROA for credit card issuers in 2007 was 4.65%, R.K. Hammer and Associates, January 2008. ROA for commercial banks in 2007 was .86%, FDIC, "Banks and Thrifts Earned \$105.5 billion in 2007," February 26, 2008.

**B. CONSUMERS HAVE SHOWN FAR MORE CAUTION IN TAKING ON CREDIT
CARD DEBT THAN ISSUERS USED IN MARKETING AND EXTENDING
CREDIT**

It is conventional wisdom that consumer demand fueled the growth of revolving debt to about \$964 billion.¹⁶ However, a careful analysis of lending patterns by credit card companies shows that aggressive and even reckless lending by issuers played a huge role in pushing credit card debt to record levels. From 1999 through 2007, creditor marketing and credit extension increased about twice as fast as credit card debt taken on by consumers,¹⁷ even though the rate of growth in credit card debt in 2007 was the highest it had been since 2000.¹⁸

The debt growth rate started slowing in the second quarter of 2008 and then experienced a rare decline in the fourth quarter.¹⁹ This most significant reason for this drop was probably the decline in consumer spending brought on by the recession. Additionally, issuers significantly

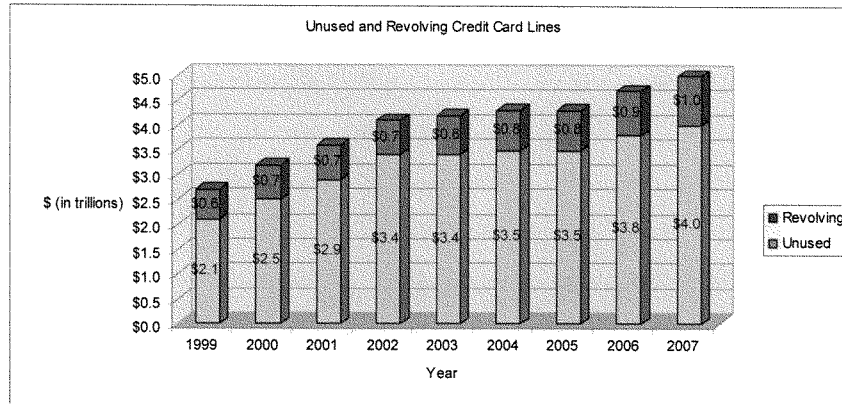
¹⁶ As of December 2008, the amount of revolving debt held by Americans was \$963.5 billion. Although this figure is often used as a proxy for credit card debt, most experts believe that outstanding credit card debt is slightly lower. First, approximately 5 percent of consumer revolving credit is not on credit cards. Second, between 4 to 9 percent of the debt does not truly revolve. It is repaid to the credit card issuer before the next billing cycle starts. Taking these two factors into account, outstanding credit card debt is likely to be between \$829 and \$877 billion.

¹⁷ VERIBANC, Inc. (www.VERIBANC.com) and Federal Reserve Consumer Credit Outstanding. According to Federal Reserve figures, consumer revolving debt grew by 50 percent from \$627.5 billion in December 1999 to \$941.4 billion in December 2007. According to VERIBANC, unused lines of credit grew at almost double the rate (90.5 percent) that consumers increased their use of credit card lines, increasing from \$2.1 trillion in 1999 to just under \$4.0 trillion (\$3,983,200,614) at the end of 2007.

¹⁸ The amount of revolving debt increased by 7.8 percent in 2007, which was the sharpest increase since revolving debt grew by 11.6 percent in 2000. Federal Reserve, Statistical Release, "Consumer Credit Outstanding," Table G.19.

¹⁹ The amount of credit card debt in the fourth quarter of 2008 dropped by 5.4 percent, from \$976.7 billion to \$963.5 billion. Federal Reserve, Statistical Release, "Consumer Credit Outstanding," Table G.19.

reduced their marketing of new credit and started reducing some existing credit lines in the latter half of 2008.²⁰



Source: VERIBANC, Federal Reserve.

A similar trend is evident when examining the consumer response to massive increases in marketing by creditors that started in 1990. The most significant form of marketing for creditors remains solicitation by mail. Over half of credit cards held by consumers are the result of mail solicitation.²¹

²⁰ Wolfe, Daniel, "Top Issuers, with Less Appetite for Risk, Slashing Credit Lines," *American Banker*, December 2, 2008. Banjo, Shelly, "Credit Card Companies Slash Credit Limits," *The Wall Street Journal*, January 5, 2009.

²¹ Vertis Inc., press release, "Financial Direct Mail Readers Interested in Credit Card Offers," January 25, 2005; "Card Marketing 101," *CardTrack*, September 2002.

Issuers increased the number of mailed credit card offerings six-fold from 1990 to 2005, from just over 1.1 billion to a record 6.06 billion.²² Since then, solicitations dropped to 5.8 billion in 2006, 5.2 billion in 2007, and 3.8 billion in 2008.²³ Wealthier families receive the highest number of credit card mailings, but low-income families are more likely to open the solicitations they receive.²⁴ The table at right indicates that issuer interest in marketing credit cards grew much faster than consumer interest in accepting new cards. The consumer response rate to mail solicitations declined seven-fold from 2.1 percent in 1990 to .3 percent in 2005, picking up slightly to .5 percent in 2006 and 2007. This means that for every 250 solicitations consumers receive, they reject more than 249. The tiny response rate demonstrates that the vast majority of consumers are being responsible when offered unsolicited credit.

²² Synovate Mail Monitor, press release, "Mail Monitor Reports Record Six Billion Credit Card Offers Mailed in U.S. during 2005," April 27, 2006.

²³ Synovate Mail Monitor, press release, "U.S. Credit Card Mail Volume Declined to 3.8 billion in 2008," January 30, 2009.

²⁴ Kidane, Amdetsion and Sandip Mukerji, Howard University School of Business, "Characteristics of Consumers Targeted and Neglected by Credit Card Companies," *Financial Services Review*, Vol. 13, No. 3, 2004 at 186.

**C. ISSUERS ENCOURAGE THE LEAST
SOPHISTICATED AND RISKIEST HOUSEHOLDS TO
RUN UP UNSUSTAINABLE LEVELS OF DEBT**

The growth of revolving debt in this country to \$964 billion has obviously not affected all Americans equally. The extraordinary expansion of the credit card industry in the 1990s was fueled by the marketing of credit cards to populations that had not had widespread access to mainstream credit, including lower- and moderate-income households, consumers with seriously blemished credit histories, college students, older Americans and minorities.

In a practice widely known as risk-based pricing, creditors charged riskier consumers more to cover potential losses, usually in the form of higher interest rates. To make the assumption of debt more attractive to these households – and to entice them into carrying debt for longer periods – creditors lowered minimum payment balances from around five percent of principal to just over two percent. As a result, an estimated eighty percent of all households now have at least one card.²⁶ According to the Federal Reserve Board, about 42 percent of cardholding households pay their credit card bill

	Solicitations (billions) ²⁵	Response Rate
1990	1.1	2.1%
1991	0.99	2.4%
1992	0.92	2.8%
1993	1.5	2.2%
1994	2.5	1.6%
1995	2.7	1.4%
1996	2.38	1.4%
1997	3.01	1.3%
1998	3.44	1.2%
1999	2.54	1.0%
2000	3.54	0.6%
2001	5.01	0.6%
2002	4.89	0.5%
2003	4.29	0.6%
2004	5.23	0.4%
2005	6.06	0.3%
2006	5.8	.5%
2007	5.2	.5%

²⁵ Synovate Mail Monitor

²⁶ Cardweb.com

in full every month,²⁷ which means that the remaining 50 million or so families that carry debt owe an average of about \$17,000.²⁸

Moderate and lower income households that are more financially vulnerable shoulder a higher level of debt relative to their incomes. In the current economic climate, these households are also under financial pressure from many external factors, such as flat wages, rising unemployment, skyrocketing home foreclosures and increasingly unaffordable health insurance. In other words, the “democratization of credit” has had serious negative consequences for many Americans, putting them one unexpected financial emergency away from bankruptcy.

Lower-Income and Minority Households

Close to half of all minority families in the U.S. carry credit card debt.²⁹ Although lower and moderate-income households are less likely to have bank credit cards than more affluent families, they are more likely to carry over debt from month-to-month. Sixty one percent of the lowest income households with a card carry balances, compared to 45 percent of higher income families.³⁰ Credit card debt also represents a significant portion of lower-income families’ income. A 2004 Gallup poll found that families with credit card debt earning under \$20,000 a

²⁷ Bucks, Brian K., Arthur B. Kennickell and Kevin B. Moore, “Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances,” *Federal Reserve Bulletin*, vol. 92, February 2006, pg. 31.

²⁸ CFA calculation based on estimated credit card (as opposed to revolving) debt of \$850 billion. If a conservative estimate of 75 percent of 114.4 million households have credit cards, and only 58 percent of these households carry debt, then the remaining 49.7 million households have an average of \$17,103 in debt.

²⁹ Bucks, Brian K., Arthur B. Kennickell and Kevin B. Moore, “Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances,” *Federal Reserve Bulletin*, vol. 92, February 2006, pg. 24.

³⁰ Board of Governors of the Federal Reserve System, “Report to the Congress on Practices of the Consumer Credit Industry in Soliciting and Extending Credit and their Effects on Consumer Debt and Insolvency,” submitted to the Congress pursuant to section 1229 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, June 2006 at 9 Table 6.

year owed 14.3 percent of their income in credit card debts, those earning between \$20,000 and \$29,999 owed 13.3 percent and those earning between \$30,000 and \$39,999 owed 11.0 percent. Compare this to the 2.3 percent of their income owed by families earning over \$100,000.³¹ The increase in credit card debt has contributed to alarmingly high overall levels of debt for many of these lower and moderate-income families. More than one-quarter of the lowest income families spent over 40 percent of their income on debt repayment in 2001.³²

Younger and Older Americans

Starting in the early 1990's, credit card issuers targeted massive marketing efforts at college campuses throughout the country, resulting in a sharp growth of credit card debt among college-age and younger Americans. CFA and Dr. Robert Manning were among the first to document the serious consequences of this trend.³³ Since Dr. Manning's report for CFA in 1999, this issue has been the subject of much public and media scrutiny. And yet, Americans under 35 years-of-age continue to show more signs of trouble managing credit card debt than any other age group. The amount of credit card debt held by students graduating from college more than doubled to \$3,262 between the mid-1990s and 2004.³⁴ Americans under 35 are less likely to pay off their credit card balances every month than average Americans,³⁵ are paying more for debt

³¹ Gallup Poll News Service, "Average American Owes \$2,900 in Credit Card Debt," April 16, 2004.

³² Aizcorbe, Kennickell and Moore 2003 at 29, Table 14. In 2001, more than one in four (27.0%) families in the lowest income quintile spent more than 40% of their income on debt payments, compared to less than one in six (16.0%) of families in the second lowest income quintile and one in nine (11.0%) of all families who spent 40% or more of their income on debt payments.

³³ Manning, Robert, "Credit Cards on Campus: Costs and Consequences of Student Debt," June 8, 1999. CFA Press Release available at: <http://www.consumerfed.org/ccstudent.pdf>

³⁴ Trigaux, Robert, "Generation Broke: New Grads Bear Heavy Load," *St. Petersburg Times*, November 22, 2004.

³⁵ Draut, Tamara, Director of Demos Economic Opportunity Program, Testimony Before the House Banking Committee Subcommittee on Financial Institutions and Consumer Credit, September 15, 2004, at 8. More than half (55%) of Americans carry revolving balances compared to 71% of borrowers aged 25-34.

obligations than in the past and are increasingly likely to pay more than 40 percent of their incomes on credit card debt.³⁶ Not surprisingly, more young Americans are declaring bankruptcy than in the past.³⁷ Moreover, there is increasing evidence that issuers are now targeting high school students with credit card offers.³⁸ They are also marketing branded debit cards to adolescents, in part to encourage these young consumers to use similarly branded credit cards when they are older.³⁹

The growth of credit card debt among older households is also troubling. Although these households were long thought to be the most frugal and resistant to consumer debt, changing economic conditions – especially declining pension and investment income coupled with rising health care and prescription costs – have made credit card debt a more serious financial issue for older Americans. Between 1992 and 2001, Americans over age 65 saw their credit card debt nearly double from \$2,143 to more than \$4,000.⁴⁰ The number of seniors filing for bankruptcy more than tripled from 1991 to 2001.⁴¹ Other warning signs are also evident. The proportion of income spent to pay off debts by households headed by individuals 65 to 74 years of age has

³⁶ *Ibid.* at 4-5. In 1992, about one in thirteen (7.9%) Americans aged 25-34 had debt greater than 40% of their income; by 2001, about one in eight (13.3%) had these high debt burdens.

³⁷ Sullivan, Theresa A., Deborah Thorne and Elizabeth Warren, "Young, Old, and In Between: Who Files for Bankruptcy?" *Norton Bankruptcy Law Advisor*, Iss. No. 9A, September 2001.

³⁸ Mayer, Caroline E., "Girls Go From Hello Kitty To Hello Debit Card; Brand's Power Tapped to Reach Youth," *The Washington Post*, October 3, 2004.

³⁹ Ludden, Jennifer, "Credit Card Companies Target Kids," *All Things Considered*, National Public Radio, February 6, 2005.

⁴⁰ Demos, "Retiring in the Red," January 19, 2004 at 3.

⁴¹ Sullivan, Theresa A., Deborah Thorne and Elizabeth Warren, "Young, Old, and In Between: Who Files for Bankruptcy?" *Norton Bankruptcy Law Advisor*, Iss. No. 9A, September 2001, at 5. The number of older Americans declaring bankruptcy during this period rose from 23,890 to 82,207.

risen steadily over the past decade⁴² while about one in seven senior households paid more than 40 percent of their income towards their debts in 2001.⁴³

Seniors have fewer credit cards than other age groups and are more likely to pay their credit cards in full every month, but a greater proportion of older Americans also have lower incomes.⁴⁴ This means that credit card debt has a more severe impact on this age group. For example, credit card debt can threaten older homeowners, who stand to lose their home – and their most significant hedge against poverty – if they use home equity to pay off credit card debt.

The Downsizing of Minimum Payments

As credit card issuers dramatically expanded their marketing and extension of credit in the 1990s, they lowered monthly minimum payment amounts. By reducing the minimum payment, issuers could offer more credit, encourage consumers to take on more debt, and ensure that consumers would take far longer to pay off their debts, thus making them more profitable for the industry.⁴⁵ Monthly minimum payment rates were reduced from around 5 percent of principal

⁴² Aizcorbe, Kennickell and Moore 2003 at 28, Table 14. According to the Federal Reserve Survey of Consumer Finances, the median debt services ratio of households aged 65-74 grew by 54% from 9.8% in 1992 to 15.1% in 2001 and the debt services ratio for households 75 and older grew 169% from 2.6% to 7.0% in 2001.

⁴³ *Ibid.* 13.9% of households aged 65-74 and 14.3% of households aged 75 and over spent more than 40 percent of their income on debt service.

⁴⁴ Hanway, Steve, "Do Credit Card Habits Improve with Age?" Gallup News Organization, May 18, 2004. Nearly half (48%) of households over 65 years old have incomes below \$30,000, compared to 16% of those aged 30-49 and 18% of those aged 50-64.

⁴⁵ Interview with Andrew Kahr, credit card industry consultant, "The Secret History of the Credit Card," *Frontline*, November 2004.

owed in the 1970s to just over 2 percent by the turn of the century.⁴⁶ In 2005, 19 million credit card borrowers make only the minimum payments.⁴⁷

The number of consumers paying just above the minimum rate is even larger. In a representative survey conducted for the Consumer Federation of America by Opinion Research Corporation in November of 2005, 34 percent of those questioned said that they usually pay the minimum rate or somewhat more. More than 40 percent of respondents earning less than \$50,000 a year said they paid the minimum rate or somewhat more, while 45 percent of African Americans and 51 percent of Hispanics did so.⁴⁸ An examination by the Credit Research Center of 310,000 active credit card accounts over 12 consecutive months in 2000 and 2001 found similar results. Just under one-third of the accounts paid 5 percent or less per month of the total amount due.⁴⁹ Moreover, payment habits for many cardholders are not static over time. Depending on the economic circumstances of the cardholder involved, he or she could shift from fully paying outstanding balances every month to paying at or near the minimum rate.

However, paying only the minimum on credit cards can increase the length of time the debt is carried and significantly add to the interest cost of the credit card loan. Julie Williams, the First Senior Deputy Comptroller and Chief Counsel of the Office of the Comptroller of the Currency (OCC) has noted that reduced minimum payments “dig borrowers into an ever deeper hole, requiring increasingly more difficult measures” for consumers to get out of debt.⁵⁰ CFA

⁴⁶ Kim, Jane J., “Minimums Due on Credit Cards are on the Increase,” *Wall Street Journal*, March 24, 2005.

⁴⁷ Der Hovanesian, Mara “Tough Love for Debtors,” *Business Week*, April 25, 2005.

⁴⁸ Opinion Research Corporation, “Consumer Financial Services Survey,” November 3-7, 2005.

⁴⁹ Credit Research Center, McDonough School of Business, Georgetown University.

⁵⁰ OCC, Remarks by Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel before the Risk Management Association’s Retail Risk Management Conference on Regulatory Concerns about Certain Retail

has concluded that reduced minimum payments were a significant cause of increasing bankruptcies in the last decade.⁵¹

One way to alert consumers to the consequences of paying off credit card balances at the minimum rate is to offer each consumer a personalized notice on the billing statement about how long it would take to pay off the balance at the minimum rate, and what would be the total costs in interest and principal.⁵² Such a personalized disclosure is, unfortunately, not included in the recent bankruptcy law, which requires consumers to call a toll-free number to get information about how long it would take to pay off their balances.⁵³ No specific information would be offered on the total cost of paying at the minimum rate. This bankruptcy law requirement will likely have no impact on the millions of consumers paying at or near the minimum rate who will not call a toll-free phone number.

One positive development regarding credit card minimum payments is that regulatory guidance issued by federal banking regulators in January 2003 directed credit card lenders to set minimum payments that “amortize the current balance over a reasonable period of time” and noted that prolonged negative amortization would be subject to bank examiner criticism.⁵⁴ Many major credit cards began increasing their minimum payments requirements in 2005, including

Banking Practices, Chicago, June 3, 2003, in “Speeches and Congressional Testimony,” *OCC Quarterly Journal*, Vol. 22, No. 3, September 2003 at 107.

⁵¹ Consumer Federation of America, “Consumer Restraint Pressures Lenders to Reduce Credit Card Marketing and Credit Extension,” January 18, 2000.

⁵² Proposed in S. 1176 by Senators Akaka, Durbin, Leahy and Schumer.

⁵³ Public Law 109-8.

⁵⁴ Joint press release of Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and Office of Thrift Supervision, “FFIEC Agencies Issue Guidance on Credit Card Account Management and Loss Allowance Practices,” January 8, 2003, see attached “Account Management and Loss Allowance Guidance” at 3.

Bank of America, Citibank, Discover and JP Morgan Chase,⁵⁵ in some cases to as high as 4 percent.⁵⁶ All issuers were required to fully phase in the changes by the end of 2006.⁵⁷

The Office of the Comptroller of the Currency (OCC) has warned banks that increasing minimum payments may need to be accompanied by a reduction in Annual Percentage Rates (APRs) or eliminating fees to ensure that cardholders can actually reduce their balances and not just tread water with higher minimum bills.⁵⁸ Since the increases took effect, consumers with interest rates above 20 percent have had to cope with payments that have roughly doubled.⁵⁹

Targeting Consumers on the Brink of Financial Distress

Nothing illustrates the perverse incentives (and dangers) of the credit card market better than the marketing of cards to consumers with tarnished credit histories, or even worse, to those who are literally on their way to or just coming out of bankruptcy. For example, in the first half of 2007, as home mortgage foreclosures shot up and signs of a serious economic slowdown started to appear, some of the nation's largest credit card issuers increased the number of solicitations they mailed to sub-prime consumers by 41 percent compared to the first half of 2006.⁶⁰

⁵⁵ American Financial Services Association, "Credit Card Minimum Payments Going Up," *Spotlight on Financial Services*, April 2005.

⁵⁶ Warnick, Melody, "Credit Card Minimum Payments Doubling," *Bankrate.com*, May 3, 2005. Citibank and Bank of America have announced they are doubling their minimum payment requirements from 2% to 4% of the balance.

⁵⁷ Day, Kathleen and Caroline E. Mayer, "Credit Card Penalties, Fees Bury Debtors," *Washington Post*, March 6, 2005.

⁵⁸ Der Hovanesian, Mara "Tough Love for Debtors," *Business Week*, April 25, 2005.

⁵⁹ "Minimum Payments," *CardTrack*, September 6, 2006.

⁶⁰ Gavin, Robert, "Credit Card Companies Pursue Subprime Borrowers," *Boston Globe*, September 5, 2007.

Other major issuers and many smaller companies market high-cost, sub-prime cards to those with blemished credit histories. This population of cardholders can be profitable for the industry. Credit card industry consultant Andrew Kahr estimates that average sub-prime consumers will make two or three late payments a year, from which the industry can generate a separate fee, and that these fees can greatly exceed the interest payments on the small lines of credit themselves.⁶¹

Sub-prime consumers haven't just encountered high-cost offers of credit, but deceptive marketing practices. In 2000, Provident was required to pay more than \$300 million in restitution to its sub-prime cardholders for unfair and deceptive practices.⁶² Cross Country Bank, the sub-prime and secured credit card issuer that has been investigated by state and federal regulators for misleading consumers about the terms of its sub-prime credit card accounts and engaging in abusive collection practices, has advertised on late-night and daytime television when more unemployed potential sub-prime customers are more likely to be watching television.⁶³

In December of 2008, sub-prime card marketer Compucredit reached a settlement with federal regulators to provide at least \$114 million in consumer redress and pay a \$2.4 million fine for deceptive marketing of high-fee, low-limit credit cards. Among other allegations,

⁶¹ Interview with Andrew Kahr, credit card industry consultant, "The Secret History of the Credit Card," *Frontline*, November 2004.

⁶² OCC, Statement of Comptroller of the Currency John D. Hawke J., June 28, 2000.

⁶³ Pacelle, Mitchell, "Pushing Plastic," *Wall Street Journal*, November 5, 2004.

Compucredit was accused of marketing cards with a \$300 limit, but failing to adequately disclose the \$185 in fees that would be immediately charged to the card.⁶⁴

Consumers exiting bankruptcy are often swamped with offers at prime terms – low interest rates and without annual fees.⁶⁵ Many bankruptcy attorneys believe these offers are being made because consumers leaving bankruptcy court cannot erase their debts for another six years. Under the new bankruptcy legislation consumers will not be able to wipe away any credit card debts for eight years. Some categories of credit card debt will not be “dischargeable” at all, no matter how long the consumer waits.⁶⁶

D. ISSUERS HAVE PURSUED ABUSIVE INTEREST RATE, FEE AND RISK MANAGEMENT POLICIES THAT HAVE A HARMFUL IMPACT ON MANY HOUSEHOLDS

There is considerable evidence linking the rise in bankruptcy in recent years to the increase in consumer credit outstanding, and, in particular, to credit card debt. For example, research by Professor Ronald Mann of Columbia University has found that an increase in credit card spending in the U.S. and four other countries has resulted in higher credit card debt, which is strongly associated with an increase in bankruptcy filings.⁶⁷ To make matters worse, credit

⁶⁴ “Subprime Credit Card Marketer to Provide At Least \$114 Million in Consumer Redress to Settle FTC Charges of Deceptive Conduct,” Federal Trade Commission, Dec. 19, 2008, <http://www.ftc.gov/opa/2008/12/compucredit.shtm>.

⁶⁵ Mayer, Caroline E., “Bankrupt and Swamped with Credit Offers,” *Washington Post*, April 15, 2005.

⁶⁶ *Ibid.*

⁶⁷ Mann, Ronald J., “Credit Cards, Consumer Credit and Bankruptcy,” Law and Economics Research Paper No. 44, The University of Texas School of Law, March 2006.

card companies have become far more aggressive in implementing questionable fees and interest rate practices in recent years. The upshot of these practices is that penalty interest rates, high and accumulating fees and interest on fees can push consumers with high debts over the financial brink into bankruptcy.⁶⁸ In fact, consumers in debt trouble sometimes owe as much or more in fees and penalty interest charges, as in principal.

High fees and interest rates can often result in negative amortization, where the principal owed on credit card debt continues to rise despite making payments. Negative amortization in effect traps credit card borrowers on a debt treadmill that keeps moving faster. Although they are making regular payments, their debts continue to mount. In 2004, a Cleveland judge ruled against Discover Card's efforts to collect debts from a cardholder whose balance nearly tripled from \$1,900 to \$5,564 without making additional purchases because of fees and penalties, including \$1,158 in over-limit fees alone.⁶⁹

In another case, a bankruptcy court in North Carolina ordered a credit card company to itemize the claims it files in chapter 13 bankruptcy cases.⁷⁰ In its findings in support of the Order, the bankruptcy judge listed claims filed in eighteen separate cases broken down between principal and interest and fees. On average, interest and fees consisted of more than half (57 percent) of the total amounts listed in the claims. In one case, the card company filed a claim in the amount of \$943.58, of which \$199.63 was listed as principal and \$743.95 was listed as interest and fees. In another case, a claim of \$1,011.97 consisted of \$273.33 in principal and

⁶⁸ Day, Kathleen and Caroline E. Mayer, "Credit Card Penalties, Fees Bury Debtors," *Washington Post*, March 6, 2005.

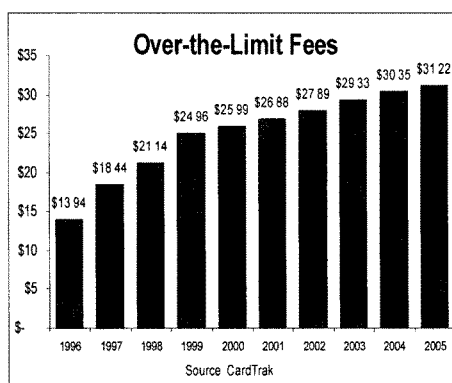
⁶⁹ National Consumer Law Center, "Responsible Consumers Driven into Default," February 22, 2005.

⁷⁰ *In re Blair*, No. 02-1140 (Bankrate. W.D.N.C. filed Feb. 10, 2004)

\$738.64 in interest and fees. It is almost certain that pre-bankruptcy payments in these cases had more than paid off the real charges made by the consumers.⁷¹

Penalty Fees

Traditionally, penalty fees were designed to deter irresponsible cardholder behavior, but in recent years these fees have become primarily a revenue enhancer for credit card issuers. An analysis by the United States Government Accountability Office (GAO) found that, "...typical cards today now include higher and more complex fees than they did in the past for



making late payments, exceeding credit limits, and processing returned payments.”⁷² The GAO also identified several new fees that issuers have begun using in recent years, some of which they are not required to disclose to consumers in advance. One example of such a fee is for the payment of bills by telephone, which can range from 5 to 15 dollars.⁷³

A substantial number of Americans are paying these fees. Thirty-five percent of the credit card accounts from the six largest issuers that the GAO examined had at least one late fee

⁷¹ National Consumer Law Center, “Responsible Consumers Driven into Default,” February 22, 2005.

⁷² “Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers,” U.S. Government Accountability Office, September 2006, p. 18.

⁷³ *Ibid.*, p. 23.

in 2005,⁷⁴ representing about 242 million credit cards.⁷⁵ Thirteen percent of all accounts – or about 90 million cards – were assessed over-limit fees in 2005.

Late fees have been steadily rising over the past decade and can easily exceed monthly payments for consumers paying low minimum balances.⁷⁶ In 1996, a Supreme Court decision prohibited states from setting limits on the fees credit card companies could charge their cardholders. Prior to this court ruling, credit card late fees were commonly around five to ten dollars, but have risen sharply since the decision.⁷⁷ The GAO analysis found that late fees jumped sharply after the court ruling. The GAO examined fee data collected by CardWeb.com and found that late fees jumped by 160 percent from \$12.83 in 1995 to \$33.64 in 2005. The GAO also found a sharp fee increase from data collected by Consumer Action, which showed a 119 percent increase from \$12.53 in 1995 to \$27.46 in 2005.⁷⁸ Even more striking, the GAO found that late fees paid by borrowers with typical balances were an average of \$37 in 2005.⁷⁹ This is important to note as credit card issuers are increasingly assessing “tiered” fees based on the borrower’s balance.

Credit card issuers used to reject transactions that exceeded a cardholder’s credit limit, but it has become common for issuers to accept the transaction and then apply an over-limit fee on cardholders who exceed their credit limits.⁸⁰ These fees are often applied by issuers in addition to a higher “penalty” interest rate charge for exceeding the credit limit or carrying a high

⁷⁴ *Ibid*, p. 1.

⁷⁵ CFA calculation based on 691 million credit cards, *Ibid*, p. 9.

⁷⁶ “The Ugly Issuer,” *Credit Card Management*, September 2004.

⁷⁷ Bergman, Lowell and David Rummel, “Secret History of the Credit Card,” *Frontline*, November 2004.

⁷⁸ “Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers,” U.S. Government Accountability Office, September 2006, p. 18.

⁷⁹ *Ibid*, p. 20.

⁸⁰ “The Ugly Issuer,” *Credit Card Management*, September 2004.

balance.⁸¹ These monthly fees are charged every month a consumer carries a credit balance higher than their credit limit. According to the GAO report, data collected by Consumer Action shows a 114 percent increase in over-limit fees between 1995 and 2005.⁸² Critics of this practice argue that issuers should not assess a penalty fee when they can simply enforce the credit limit if they wish to prevent consumers from exceeding it.

Penalty Interest Rates

The vast majority of credit card issuers also increase interest rates for credit card account holders who pay their bills late, even by a few hours. In 2005, Consumer Action found that 78.7 percent of issuers charged penalty rates for late payments on their cards.⁸³ For example, representatives for one large issuer told the GAO that they automatically increase a customer's interest rate if this person pays late or exceeds the credit limit. The GAO found that all but one of the 28 cards from the six largest issuers they reviewed charged default rates in 2005. By 2008, 94% of new credit card solicitations included a penalty rate.⁸⁴ The average default rate in 2008 is 28.6 percent, up from 23.7 percent in 2003.⁸⁵ Even more striking, the spread between the

⁸¹ Bergman, Lowell and David Rummel, "Secret History of the Credit Card," *Frontline*, November 2004.

⁸² "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 20.

⁸³ Consumer Action, 2005 Credit Card Survey, "Card Companies Use Common 'Risk Factors' to Impose Unfair Rate Hikes, Finds CA," *Consumer Action News*, Summer 2005.

⁸⁴ Frank, Joshua M., *Priceless or Just Expensive? The Use of Penalty Rates in the Credit Card Industry*, p. 10, Center for Responsible Lending (December 16, 2008), hereafter Frank, *Priceless or Just Expensive*, available at <http://www.responsiblelending.org/pdfs/priceless-or-just-expensive.pdf>.

⁸⁵ *Id* at 9. (The 2006 GAO report did find that some issuers do not assess default rates unless there are multiple violations of card terms. "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, pgs. 24, 25.)

penalty rate and the standard purchase rate more than doubled between 2000 (8.1%) and 2008 (16.9%).⁸⁶

Some consumers with low-rate cards could have their interest rates double overnight for being late on one payment to their credit card.⁸⁷ Some issuers also say that they will charge default interest rates for exceeding the credit limit on the card or for returned payments, or that they will increase interest rates for cash advances and balance transfers for violations of card terms.⁸⁸

There is increasing evidence that those who can least afford these higher interest rates – financially vulnerable families – are most likely to be paying them. A study by the research organization Demos found that cardholders that carry debt who earn less than \$50,000 a year are more than twice as likely to pay interest rates above 20 percent as the highest income Americans who carry debt. African-American and Latino credit card holders with balances are more likely than whites to pay interest rates higher than 20 percent.⁸⁹

One recent study estimated that the cost of the penalty rate shock cost a revolver carrying the average \$10,678 balance \$1800 a year.⁹⁰ At a time when we are looking for ways to put money back in the hands of families, reducing this \$150 a month surtax could have a real stimulative effect.

⁸⁶ Frank, *Priceless or Just Expensive*, at 9-10.

⁸⁷ Bergman, Lowell and David Rummel, "Secret History of the Credit Card," *Frontline*, November 2004.

⁸⁸ "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 25.

⁸⁹ Wheary, Jennifer, and Tamara Draut, "Who Pays? The Winners and Losers of Credit Card Deregulation," Demos, August 1, 2007.

⁹⁰ Frank, *Priceless or Just Expensive*, at 1.

Retroactive Application of Penalty Rates

All issuers also apply penalty interest rates retroactively to prior purchases. This has the effect of increasing the price on purchases already made but not paid off.⁹¹ Some cards even apply penalty rates to debts that were already paid at a lower rate.⁹² There is simply no legal or economic justification for assessing a penalty interest rate to an existing balance. There is no other industry in the country that is allowed to increase the price of a product once it is purchased. Issuers have already assessed a consumer's risk of not repaying the loan and presumably offered an interest rate based on that risk. Issuers should be required to allow a consumer to pay off his or her existing balance at that interest rate.

Even for consumers who clearly are becoming higher risk, such as those who are a full thirty days late in paying a credit card bill, it is harmful to cardholders and, ultimately, lenders to impose a retroactive rate increase on the existing balance. These families are struggling and need help getting out of debt; they should not be shoved deeper underground. Retroactive penalty interest rate hikes for these cardholders only increases the likelihood that they will completely default, which is in no one's interest. The primary effect of a punitive retroactive rate increase appears to be to escalate the proportion of the consumer's debt owed to the card issuer and to put the card issuer at an advantage over the consumer's other creditors. This

⁹¹ Draut, Tamara, Director of the Economic Opportunity Program at Demos, Testimony Before the House Banking Committee Subcommittee on Financial Institutions and Consumer Credit, September 15, 2004, at 16-17.

⁹² McGeehan, Patrick, "The Plastic Trap," *New York Times*, November 21, 2004. Discover disclosed to its customers that it had changed the terms of its interest rates from a low of zero to 19.99% for a single late payment, but it applied that rate increase for late payments from 11 months prior to the disclosure of the changing interest rate terms.

practice is unfair to creditors who do not escalate the debt owed by families having difficulty making ends meet.

Universal Default

Universal default clauses in credit card contracts allow credit card companies to raise interest rates on debtors who have problems with other creditors or whose credit scores decline. The increases are triggered not just by a late mortgage or credit card payment to other lenders but also to payment disputes with other types of creditors, like utilities or book clubs.⁹³ A review of credit card disclosures issued in October 2006 by Consumer Action found five major issuers that said they reserved the right to assess universal default interest rates. Since that time, Citigroup and JP Morgan Chase have said that they will not use the practice, although Citigroup changed this policy in the fall of 2008.⁹⁴ On the other hand, representatives for Bank of America and Discover testified before the Senate late last year that they still use consumer credit scores, at least in part, to trigger higher default interest rates.⁹⁵

It is fundamentally unfair to impose a penalty interest rate on a consumer who has not made a late payment or defaulted on an obligation, especially when this rate increase is applied retroactively. Another concern with using credit reports to trigger a penalty rate is the problems with inaccuracies in credit scoring and credit reporting that CFA and other organizations have

⁹³ Burt, Bill, "Pay One Bill Late, Get Punished by Many," *Bankrate.com*, January 20, 2004.

⁹⁴ Dash, Eric, "Despite Pledge, Citigroup to Raise Credit Card Rates, Blaming 'Difficult' Environment," *New York Times*, November 15, 2008.

⁹⁵ Credit Card Practices: Unfair Interest Rate Increases, U.S. Senate Permanent Subcommittee on Investigation, December 4, 2007.

documented.⁹⁶ Moreover, issuers who impose sharp interest rate increases on consumers who are meeting their obligations often fail to provide any rationale – much less a legitimate one -- for the increase. In January, Bank of America began increasing interest rates on some cardholders to as high as 28 percent but did not inform consumers the reason for the increase in the notification they mailed.⁹⁷

Although credit card issuers contend that interest rate penalties that increase because of universal default are related to the credit risk of the borrower, the application by some issuers of these punitive rate hikes seems to belie that contention. One late payment can result in significant increases in interest rates in some cases, even though there is little evidence that a single late payment to one creditor increases the likelihood of default to all creditors. Moreover, increased fee and interest rate payments may have a similar or greater impact on the borrower's ability to repay than modest problems with another creditor.

Indiscriminate, Undisclosed Changes in Rates and Fees

Many credit card companies reserve the right to change the terms of their credit card contract at any time and for any, *or no*, reason. This allows credit card companies to arbitrarily raise interest rates even for cardholders in good standing and with perfect credit histories. Media reports of recent rate hikes by Bank of America demonstrate the unfairness of any-time/any-

⁹⁶ Consumer Federation of America and National Credit Reporting Association, "Credit Score Accuracy and Implications for Consumers," December 17, 2002. CFA and NCRA reviewed over 500,000 credit files and found that 29 percent of consumers have credit scores that differ by at least 50 points between the credit bureaus.

⁹⁷ "A Credit Card You Want to Toss," *Business Week*, February 7, 2008.

reason changes: some consumers saw their interest rates triple without explanation.⁹⁸ The result of these unfair clauses is that consumers can't depend on the interest rate promised to them.

In the last few months, JP Morgan Chase has begun charging approximately 400,000 cardholders a \$10 a month fee. It is also increasing the minimum payment amount for these consumers from 2 to 5 percent, a substantial amount. Many of these cardholders appear to have been promised a fixed interest rate for the life of the balance.⁹⁹

Pricing Tricks: Double Cycle Billing and Manipulation of Payment Allocation

The GAO found that two of six major creditors are using a practice called double-cycle billing, which results in illegitimate interest charges on balances that have already been paid on time.¹⁰⁰ Since then, one of these issuers, JP Morgan Chase, has announced that it will no longer use double-cycle billing. With this practice, issuers consider two billing cycles in assessing interest. A consumer who begins with no balance and pays off most but not all of the purchases he or she makes in the first month would still be charged interest for the entire amount of the balance in the second month. A fair billing process would only result in an interest charge on the amount of the unpaid balance.

⁹⁸ Ibid.

⁹⁹ Chu, Kathy, "Chase Adds Fee for Low-Rate Credit Cards," *USA Today*, February 9, 2009.

¹⁰⁰ "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 27.

The GAO also determined that for 23 of the 28 large issuer cards they reviewed, cardholder payments were first allocated to the balance assessed at a lower rate of interest.¹⁰¹ The actual proportion of large issuers who in effect use this policy is likely closer to 100 percent since the remaining five issuers applied payments “subject to their discretion”. This practice is problematic for the many cardholders who now carry balances at different rates of interest, such as introductory “teaser” rates, cash advance rates, and balance transfer rates. The lower interest rate balances must first be paid off before the issuer will allocate payments to higher rate balances. Allocating payments to lower interest rate balances first unfairly extends the length of time it takes consumers to pay down their balances while increasing the finance charges that issuers earn. Furthermore, a recent study has shown this payment allocation policy and its impact to be very poorly understood by consumers.¹⁰² The study also showed this issuer policy causes pricing to be less related to risk, the opposite of what issuers claim they wish to achieve.

Increases in Credit Card Fees and Interest Rates Significantly Affect Consumer Debt

Penalty fees and interest made up more than three-quarters of credit card issuers revenues throughout 2002 and 2003. Credit card issuers earned \$65.4 billion in interest and \$7.7 billion in penalty fees in 2003 or 75.7 percent of the total \$96.5 billion in revenue.¹⁰³ In 2002, penalty fees and interest made up 76.8 percent of the industry’s \$97.1 billion in revenues. For the

¹⁰¹ *Ibid.*

¹⁰² Frank, Joshua M., *What's Draining Your Wallet? The Real Cost of Credit Card Cash Advances*, Center for Responsible Lending (December 16, 2008), available at <http://www.responsiblelending.org/pdfs/whats-draining-your-wallet.pdf>

¹⁰³ Daly, James J., “Smooth Sailing,” *Credit Card Management*, May 2004 at 31.

approximately 88 million credit cardholding households, penalty fees and interest on their credit card debt cost an average of \$830 in 2003.¹⁰⁴

Unsavory Credit Limit Practices

In its 2008 survey of credit card terms and conditions, Consumer Action identified some unsavory credit limit practices used by major credit card issuers. While reducing credit availability can be a responsible way for credit card issuers to manage growing financial risk during difficult economic times, these aggressive credit line policies can harm consumers. Each in its own way puts consumers at greater risk of being charged higher interest rates, falling deeper in debt, and causing a ripple effect among issuers. Consumers reported some credit limit practices to Consumer Action that are patently unfair.

- Following you down. As consumers pay off large balances, the credit limit is reduced so that the balance is always close to the credit limit.
- Sorry, you're over limit. Credit limits are reduced to levels lower than the current balance, triggering over limit fees and requiring a large "balloon" payment of the over-due amount. This practice also puts the consumer at risk of being hit with a penalty interest rate.
- Where's my credit limit? Cards are declined at the point of purchase, and only then do cardholders find out that their limits have been reduced with no warning.

¹⁰⁴ CFA calculation from Daly, James J. 2004 and Census Bureau figures.

- Ganging up on consumers. One credit card issuer lowers your credit limit, which lowers your credit score, which causes another of your cards to lower your credit limit.

The Combined Effect of Abusive Practices during the Recession

Although credit card issuers have curbed aggressive marketing and cut back on credit extension in the last year, they appear to be accelerating the use of many of the irresponsible and harmful practices detailed above to cut or mitigate their losses. For example, card issuers have used their ability to unilaterally change the terms of credit card contracts by raising interest rates even as the Federal Reserve has sharply reduced the federal funds rate.¹⁰⁵ They have also added new fees,¹⁰⁶ increased the amount of fees,¹⁰⁷ and, as detailed above, used harmful rather than responsible methods to lower credit lines. Citigroup back-peddled last fall on its promises not to increase interest rates “at any time for any reason.”¹⁰⁸ As mentioned above, Chase has suddenly started charging hundreds of thousands of cardholders fees of \$120 a year, while sharply increasing the monthly amount that these cardholders owe each month. Bank of America and Capital One have used vague clauses in cardholder agreements to raise interest rates on cardholders because of “market conditions.”¹⁰⁹ Issuers have every right to try and limit their losses during the current economic crisis if they act responsibly, but the use of these harmful,

¹⁰⁵ Trejos, Nancy, “Less Power to Purchase, Consumers’ Credit Card Limits Slashed as Companies Try to Reduce Risk,” *Washington Post*, November 16, 2008.

¹⁰⁶ Lieber, Ron, “Credit Card Companies Go to War Against Losses,” *New York Times*, January 31, 2008.

¹⁰⁷ Trejos, Nancy, “Less Power to Purchase, Consumers’ Credit Card Limits Slashed as Companies Try to Reduce Risk,” *Washington Post*, November 16, 2008.

¹⁰⁸ Dash, Eric, “Despite Pledge, Citigroup to Raise Credit Card Rates, Blaming ‘Difficult’ Environment,” *New York Times*, November 15, 2008.

¹⁰⁹ “Card Rates Rise ‘Out of the Blue,’” *The Oregonian*, January 25, 2008. Kimes, Mina, “Card Companies Jacking Up Rates,” *Cable News Network*, http://money.cnn.com/2008/09/26/news/economy/creditcards_kimes.fortune/.

unjustified and sometimes arbitrary practices is contributing to the economic insecurity of millions of families who thought they were complying with their obligations.

When “Risk-Based” Pricing is Predatory

Credit card issuers often claim that their interest rate and fee policies are justifiable because they are necessary to compensate for the increased financial risk of lending to borrowers with blemished or limited credit histories. It is true that borrowers who pay their balance every month are receiving a valuable service at no cost in many cases. It is quite possible, in fact, that riskier borrowers who revolve their debt and pay higher interest rates and fees are subsidizing in part the cost of services that these non-revolvers receive. It is important to note, though, that issuers still receive substantial fee income from merchant “interchange” fees and, in some cases, from annual fees.

The key question is whether interest rates and fees charged to riskier consumers are fair and can be legitimately related to the actual financial risk incurred by creditors. There is increasing evidence that the answer to this question is “no.”¹¹⁰ It is becoming more apparent that many of the most abusive fees and interest rates are assessed simply because it is what the market will bear.

The amount of fees and penalty interest rates do not appear to be proportional to the risk or cost incurred by issuers. For many years, issuers have justified “sticky” interest rates that rise

¹¹⁰ Testimony of Adam J. Levitin, Associate Professor of Law, Georgetown University Law Center, before the Subcommittee on Financial Institutions and Consumer Credit of the Financial Services Committee of the United States House of Representatives, March 13, 2008.

faster than they decline by stating that these higher interest rates were necessary to compensate for increased risk. As issuers have increased the number and amount of fees and penalty interest rates they charge, it seems that higher baseline interest rates alone are not sufficient anymore to compensate for risk. There is very little evidence that relatively modest problems, like one or two late payments of a short duration – significantly increase a consumer’s chances of default. It would appear to be impossible to justify charging a consumer with a reasonably good credit history with a late payment fee of \$35 and a default interest rate of 29 percent on prior purchases, in addition to the finance charge the consumer would already pay on a fairly high interest rate, such as 17 percent. One sign that default rates may not be truly reflective of costs or risk incurred by issuers is that the “fixed amount” that issuers add to the index rate in setting default rates rises when the cost of funds declines. The GAO found that this fixed amount increased from about 19 percent in 2003 to 22 percent in 2005 on the 28 large issuer cards they evaluated.¹¹¹

In response to these “tell-tale” signs of price gouging, it is time for issuers to provide more information to lawmakers and to the public about their real costs to demonstrate that their pricing practices are truly fair.

¹¹¹ “Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers,” U.S. Government Accountability Office, September 2006, p. 24.

E. AMERICANS ARE HIGHLY CRITICAL OF MANY CURRENT CREDIT CARD PRACTICES

Our organizations regularly conduct public opinion surveys regarding consumer attitudes and behavior. We have rarely encountered the kind of broad, nearly universal condemnation that Americans have for many common practices used by credit card issuers regarding interest rates, fees and the extension of credit.

For example, a nationally representative poll of 1,005 adults conducted by the Opinion Research Corporation for the Consumer Federation of America from September 13 to September 16, 2007 found that:

- 82 percent of Americans think it is unfair to offer several credit cards to a student with little income. (62 percent believe it is very unfair.)
- 91 percent of Americans think it is unfair to raise interest rates or fees at any time for any reason. (76 percent believe it is very unfair.)
- 83 percent of Americans think it is unfair to increase the interest rate on one card because of a person's payment history on another card. (62 percent believe it is very unfair.)
- 84 percent of Americans think it is unfair to apply interest rate increases not only to new balances but also to past balances. (61 percent believe it is very unfair.)
- 85 percent of Americans think it is unfair to increase an interest rate to 30 percent for making two late payments. (64 percent believe it is very unfair.)
- 76 percent of Americans think it is very unfair to charge \$30 for making a late payment. (51 percent believe it is very unfair.)

- 82 percent of Americans think it is unfair to charge a \$30 fee each month if a balance is over the credit limit when a person is no longer using the card. (64 percent believe it is very unfair.)
- 90 percent of Americans think it is unfair to charge \$10 for payment by phone. (72 percent believe it is very unfair.)
- 80 percent of Americans think it is unfair to not allow a person to pay off higher-interest rate debt first, such as on a cash advance, but instead applying payments first to lower-rate debt. (54 believe it is very unfair.)
- 81 percent of Americans think it is unfair to have only one week between the time a person receives a monthly statement and the time he or she must mail the payment. (54 percent believe that it is very unfair.)
- 93 percent of Americans think it is unfair to charge a late fee even though a person has mailed the payment a week or more in advance of the due date. (79 percent believe that it is very unfair.)
- 71 percent of Americans think it is unfair to require that disputes be settled by mandatory arbitration without being allowed to go to court. (45 percent believe that it is very unfair.)

F. FEDERAL RULE ON UNFAIR AND DECEPTIVE CREDIT CARD PRACTICES

On December 18, 2008, the Federal Reserve Board, the Office of Thrift Supervision and the National Credit Union Administration issued a final rule to curb unfair and deceptive practices by credit card issuers. The rules would not take effect until July 1, 2010.¹¹²

The new rule would prohibit or restrict a number of abusive practices, including:

¹¹² Federal Reserve System, 12 CFR Part 227 [Regulation AA; Docket No. R-1314]; Department of the Treasury, Office of Thrift Supervision, 12 CFR Part 535 [Docket ID. OTS-2008-0027] RIN 1550-AC17; National Credit Union Administration, 12 CFR Part 706, RIN 3133-AD47; Unfair or Deceptive Acts or Practices.

- **Interest rate increases on existing balances, unless the cardholder is more than 30 days delinquent.** The rule would not prohibit prospective “universal default” rate increases because of a supposed problem that the cardholder has with another creditor. It does eliminate the practice as applied retroactively, which has provided a major financial incentive for issuers to use it. The rule would also prohibit issuers from increasing interest rates on existing balances because a cardholder has made a minor mistake, such as paying late by a few days.
- **Payment allocation methods that cause debts to escalate.** Credit card issuers would be required to more fairly apply the payments that cardholders make to balances with different interest rates. When consumers transfer balances with low, short-term “teaser” rates (that have higher rates for new purchases), or take out high-rate cash advances, issuers would be required to apply payments either to the higher rate debt or to both the higher and lower rate debt proportionately. Currently, credit card issuers apply payments only to the lower rate debt.
- **Interest charges on debts that have already been paid.** The proposal would forbid “double cycle billing,” which results in cardholders paying interest on debts paid off the previous month during the grace period.
- **Excessive fees for low-credit cards.** The proposal would forbid credit card companies that target consumers with poor credit histories from requiring consumers to pay fees that

amount to more than half of the credit being offered, if those fees are charged to the card that is being issued. If the fees being charged to the card amount to more than one-quarter of the credit line, cardholders would be allowed to pay these fees off over a six-month period.

The rule is an important first step in stopping issuers from using some unfair and deceptive practices to increase the amount of debt consumers owe. However, it is not helpful to consumers struggling to pay off hefty debts in the middle of a recession to allow issuers to continue to use for another year and a half practices that federal regulators have deemed to be abusive. We urge this Committee to provide consumers with more timely relief, and to address abusive practices that are not targeted or completely eliminated by the rule. The Credit CARD Act achieves both of these goals. (See Section H for discussion of this and other legislation introduced in the Senate.)

G. ENSURING THAT CREDIT CARD ISSUERS RECEIVING GOVERNMENT ASSISTANCE OFFER LOANS THAT ARE FAIR AND SUSTAINABLE

As part of the federal government's efforts to rescue the financial sector, credit card banks are receiving taxpayer assistance in several forms, including through the direct infusion of funds and the Troubled Assets Relief Program (TARP). On February 10th, Treasury Secretary Geithner announced that he would expand an additional program designed to make consumer credit more widely available. The Term Asset Backed Securities Loan Facility (TALF) would

use the Federal Reserve Board's credit facility power, be operated by the Federal Reserve Bank of New York, and include a special purpose vehicle capitalized from TARP funds. Initially, the program was to use \$20 billion to support a program for up to \$200 billion in non-recourse loans to buyers of securities backed by non-mortgage debt, including consumer credit card debt. In other words, buyers of credit card securitizations would be able to borrow funds from the Federal Reserve Bank of New York to purchase these securitizations, with repayment from revenues from the securitized credit card debts. Secretary Geithner said he wants to expand the program to support between \$500 billion and \$1 trillion in lending.

A diverse coalition of more than twenty organizations led by Consumers Union has called on Secretary Geithner to require that any securitized debt whose purchase is financed through this program meet standards for fairness and truthfulness, including those standards were finalized in December 2008 by the Federal Reserve Board.¹¹³ The groups sought this change to ensure that any consumer credit card debt facilitated through this taxpayer-backed program will promote, rather than damage, household economic stability.

Specifically, the organizations called on Secretary Geithner to impose two minimal eligibility conditions on all financing by the TALF for credit card securitization pools:

1. Immediate compliance with details of the rule against unfair or deceptive acts or practices for all consumer credit card debt in the pool; and

¹¹³ <https://mail.consumerfed.org/exchweb/bin/redir.asp?URL=http://www.consumersunion.org/pdf/TALF.pdf>.

2. A specific program for cardholders to earn a reduction in penalty interest rates back to a lower standard rate after no more than six months of on-time payments for all consumer credit card debt in the pool.

Any government backed program to make capital available for credit card debt must be limited to that credit card debt which is not associated with practices that federal regulators have determined to be unfair or deceptive. Federal backing of credit card securitizations must also be limited to credit card debt with a clear “road map” to non-penalty rates for households who pay on time while under a penalty rate.

A stated purpose for the Troubled Assets Relief Program (TARP) is to restore stability to the financial system. However, the first installment of TARP money did not even begin to promote financial stability for borrowers, homeowners, and communities in the face of the tide of foreclosures, onerous credit card practices, and the crying need for affordable, sustainable, systematic loan modifications. The new TALF program for non-mortgage debt should limit its offer of liquidity to avoid the type of credit card debt that detracts from sustainable lending and household financial stability.

Providing more capital for credit card lending will not meet the national need for enhanced financial stability for households if the credit card debt that is facilitated under the TALF can continue until July 1, 2010 to contain the harmful terms and practices that the Federal Reserve Board and two other federal regulators have identified as unfair or deceptive. The challenges for the U.S. economy are great. Consumers cannot be the engine of economic

recovery if they are burdened with high interest rate credit card debt that federal regulators have determined is not justified. Any further taxpayer assistance to credit card issuers must include conditions that will ensure that the credit provided will promote, or at least not be detrimental to, family economic stability.

H. SENATE CREDIT CARD LEGISLATION

The Credit CARD Act

For more than a decade, Senator Dodd has often been a lonely voice for credit card reform in Congress. Our organizations commend Senator Dodd and his co-sponsors for introducing a comprehensive proposal that provides a range of protections for consumers well beyond that provided by the federal regulators' rule. The Credit CARD Act of 2008 targets the most abusive practices used by credit card issuers, including:

- **Eliminates unjustified interest rate hikes and unfair "any-time/any-reason" contract clauses.** Card issuers would be required to adhere to the basic principle of fair dealing — a deal is a deal. The Credit CARD Act prevents card issuers from hiking interest rates retroactively on existing balances except for adjustments to variable rates or teaser rates that expire. This will require issuers to be honest about the price of a card up front, rather than using bait and switch tactics and hair trigger penalty rates to double or even triple the rate on debt already incurred. The bill also eliminates the widely-decried practice of "universal default" — raising rates for cardholder behavior unrelated to the

card — and card issuer use of "any-time/any-reason" fine-print clauses to impose arbitrary rate hikes.

- **Prohibits retroactive interest rate hikes and requires honest, fair penalty rates.**

Under the Act, issuers would not be allowed to increase the interest rate on purchases already made when the rate was lower, though prospective interest rate increases would be allowed. If the issuer does impose a penalty rate, it must tell the consumer exactly why and limit the penalty to six months if the consumer commits no further violations. Issuers must tell consumers in the card agreement the specific actions that will trigger a penalty rate, such as paying late by more than 30 days. Currently, issuers often impose penalty rates for minor transgressions or for no reason the consumer can even discern.

- **Limits excessive and growing penalty fees.** The Government Accountability Office reports that penalty fees have increased sharply in the past ten years, faster than the cost of living (late fees now approach \$40). The Credit CARD Act would require that penalty fees be reasonably related to the costs that credit card issuers incur because of a late payment or over-limit transactions and would appropriately prohibit card issuers from charging interest on penalty fees.

- **Prohibits late fees for on time payments.** The Act would prohibit late fees upon proof of mailing seven days prior to the due date and rein in the trend toward ever-shrinking repayment periods that have led to increased imposition of late fees by requiring card issuers to mail cardholders' statements within 21 days of the due date.

- **Gives cardholders greater choice.** First, the Act would allow consumers to instruct the issuer to deny any transaction that would trigger an over limit fee. Today, consumers are charged over-limit fees even when the card issuer approves the transaction that triggers the fee. Second, the Act would require card companies to provide consumers with at least 45 days notice before increasing their interest rate, giving the consumer time to find an alternative credit card provider. Third, it would give consumers the absolute right to cancel the card when the interest rate is increased and prohibit the application of the interest rate hike when the account has been closed. And fourth, consumers' would have the right to reject a card before the account is added to their credit report. Currently, when consumers respond to card solicitations based on a favorable promotional rate but then receive a card with far less favorable terms, the account appears on their credit report before they have the right to reject the modified terms.
- **Eliminates abusive and hidden finance charges.** First, the Credit CARD Act prohibits card issuers from imposing finance charges on balances repaid during the grace period. This so-called practice of "double-cycle" billing is both hidden from consumers and difficult to understand even when consumers are aware of it. Second, when consumers hold balances at different interest rates on the same card, card issuers would be required to allocate any payments made to the highest rate balance first. Currently, card issuers often prohibit consumers from paying off high-interest rate balances until the lowest-rate balance is reduced to zero — a practice that is almost never in the cardholder's best

interest because it imposes excessive finance charges and causes higher APR balances to compound without any reduction in the higher rate portion of the balance.

- **Limits aggressive marketing, and irresponsible lending, to young consumers without the ability to repay debt.** Credit card issuers would be unable to provide credit cards to consumers under age 21 unless the consumer has a responsible cosigner, can demonstrate ability to repay, or takes a certified financial literacy or financial education course. In addition, consumers under the age of 21 would be allowed to choose whether to allow credit reporting agencies to sell their name to an issuer sending credit card solicitations. Card issuers could only send credit offers to young consumers prescreened by a credit reporting agency if they receive express, advance consent.

By exceeding the requirements of the recently finalized credit card rule finalized by federal regulators or targeting abuses not addressed by the rule, the Credit CARD Act would offer significantly more protection to consumers. Provisions that exceed the rule's requirements include the complete prohibition of the practices of universal default and the assessment of retroactive interest rates. In contrast, the credit card rule would not prohibit card issuers from increasing interest rates because activity unrelated to the card, if the increase is applied to new purchases. The rule would also continue to allow issuers to assess rate increases on existing balances when the borrower pays late by more than 30 days. At a time of economic crisis, when Congress is considering legislation to assist mortgage borrowers who have fallen behind on loans, it is not good public policy to allow issuers to double or triple interest rates on existing balances for credit cardholders who have missed a payment. In these cases, issuers should be

encouraged to take other, less damaging steps to limit their financial risk, including the responsible reduction or freezing of credit lines. The Credit CARD Act also provides more protection to consumers than the federal rule by requiring issuers to allow consumers to pay off their lowest interest rate debt first, rather than providing issuers with the choice of allowing cardholders to pay off both high and lower interest rate debts proportionately.

Provisions of the Credit CARD Act that target serious, abusive practices that are not addressed at all by the credit card rule, include: prohibiting “any-time, any-reason” changes to fees and rates; requiring issuers to ensure that penalty fees are reasonably related to the costs they incur; mandating that penalty interest rates must be lowered after no more than six-months of on-time payment by the cardholder; providing young consumers with a real choice about whether they want to receive credit card solicitations, and prohibiting issuers from offering loans to consumers between the ages of 18 and 21 unless they have the ability to repay the amount offered.

Taken together, the reforms offered in the Credit CARD Act would make the credit card marketplace fairer and more transparent. By prohibiting issuers from using questionable methods to sharply increase “back end” fees and interest charges, this bill would shift pricing in the industry to the “front end,” especially the initial interest rate. It would encourage issuers to compete to attract consumers based on those initial charges, and to use responsible risk-management techniques to manage their financial exposure if the risk profile of the borrower declines over time. The bill would not stop issuers from using responsible risk-based pricing

methods to establish initial interest rates or to change them prospectively if the borrower's credit worthiness declines.

Other Senate Proposals

We also commend Senators Schumer and Udall, Senator Levin and Senator Menendez for the legislation they have introduced to curb abusive credit card practices. The Schumer/Udall bill (S. 235) would largely codify the credit card rule finalized by federal regulators, with a few improvements and additions. It is the companion to legislation proposed by Representative Carolyn Maloney in the House of Representatives, which passed that body by a large bipartisan majority in September of 2008. Senators Levin and Menendez have offered sweeping proposals that have common provisions with each other and with the Credit CARD Act. Of particular importance to consumers is a requirement, which both the Levin (S. 1395, 110th Congress) and Menendez bill (S. 392) contain, that is designed to prevent sharp, unaffordable increases in interest rates. The bills would prohibit credit card issuers from increasing interest rates for any reason by more than 7 percentage points.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY
FROM ADAM J. LEVITIN**

Q.1. Access to Credit: A potential outcome of the new rules could be that consumers with less than a 620 FICO score could be denied access to a credit card. Such an exclusion could affect 45.5 million individuals or over 20 percent of the U.S. population.

Without access to traditional credit, where do you believe that individuals would turn to finance their consumer needs?

A.2. I am unsure to which “rules” the question refers; I assume it refers to the recent unfair and deceptive acts and practices regulations adopted by the Federal Reserve, Office of Thrift Supervision, and National Credit Union Administration under section 5 of the Federal Trade Commission Act. If so, I strongly but respectfully dispute the premise of the question; the scenario that is presented is exceedingly alarmist. The question wrongly implies that all individuals with FICO scores of 620 or lower currently have access to “traditional” credit cards. They assuredly do not. First, nearly 10 percent of the United States adult population is “unbanked,” and that means almost by definition that they do not have credit cards; card penetration into the unbanked market is *de minimis*. Thus, at least half of the impact implied by the scenario is not possible. For the remaining 10 percent or so who have FICOs under 620, many do not currently have access to “traditional” credit. Instead, they have access to predatory new credit products like “fee harvester” or “secured” credit cards. Even if these non-traditional products were included in the term “traditional,” I think it is also dubious that all or even most of them would cease to be able to get “traditional” credit; nothing in the proposed regulations limits issuers’ ability to protect against credit risk through either lower credit limits or higher interest rates or other fees.

To the extent that these individuals are not able to get credit cards or choose not to accept them because of onerously high interest rates, the answer to where they would turn for financing needs depends on the particular circumstances of the individual, but I believe that many consumers would first cut down or eliminate non-essential expenses, which would reduce their financing needs. Demand for credit is not entirely inelastic. For these consumers’ remaining financing needs, many would turn to family and friends for assistance. See Angela Littwin, *Testing the Substitution Hypothesis: Would Credit Card Regulations Force Low-Income Borrowers into Less Desirable Lending Alternatives?* 2009 ILL. L. REV. 403, 434–35 (2009) (noting that borrowing from family and friends is the most frequent form of borrowing for low-income women). It is also important to note that empirical evidence suggests that “credit cards are actually among low-income consumers’ least-preferred sources of credit, meaning that there is no “worse” alternative to which they would turn if credit card access were reduced.” *Id.* at 454.

Beyond family and friends, there are also other legitimate, high-cost sources of credit besides credit cards—pawn shops, rent-to-own, and overdraft protection, *e.g.* There, of course, is a possibility that some low-income consumers will turn to illegitimate sources of credit, such as loan sharks, but this possibility could be tempered by community-based small loan programs. Indeed, given that the

Federal Government is currently subsidizing credit card lending through the Term Asset-Backed Securities Lending Facility (TALF), it seems quite reasonable to support other forms of consumer credit lending. Indeed, in Japan, where there is a 20 percent usury cap, credit rationing and product substitution are significantly tempered by a government-supported small loan system. Nor is it clear that the terms on which “loan sharks” lend are actually worse than some subprime credit card products. As Woody Guthrie sang in the Ballad of Pretty Boy Floyd:

Now as through this world I ramble
 I see lots of funny men
 Some will rob you with a Six gun
 And some with a fountain pen.
 But as through your life you travel
 As through your life you roam
 You won't never see an outlaw
 Drive a family from their home.

WOODY GUTHRIE, AMERICAN FOLKSONG 27 (1961).

Finally, given the terms on which individuals with FICO scores of under 620 are able to obtain “traditional” credit, I think it is quite debatable whether “traditional” credit is in any way beneficial to them; fee-harvester cards and other subprime credit card products are as likely to harm consumers with poor credit ratings as they are to help them; these cards can improve consumers’ credit scores over time, if the consumer is able to make all the payments in full and on time, but by definition a consumer with a FICO of under 620 is someone who is unlikely to be able to do that.

Q.2. Risk-Based Pricing: Banks need to make judgments about the credit-worthiness of consumers and then price the risk accordingly. Credit cards differ from closed-end consumer transactions, such as mortgages or car loans, because the relationship is ongoing. I am concerned by the Federal Reserve’s new rules on risk-based repricing for a couple of reasons. First, without the ability to price for risks, banks will be forced to treat everyone with equally stringent terms, even though many of these individuals perform quite differently over time. Second, without a mechanism to reprice according to risk as a consumer’s risk profile changes, many lenders will simply refuse to extend credit to a large portion of the population.

Do you believe that consumers will have access to less credit and fewer choices because of the Fed’s new rule? If so, is this a desirable outcome?

A.2. Again, I respectfully disagree with the premise of the question. The new uniform Unfair and Deceptive Act and Practices regulations adopted by the Federal Reserve Board, the Office of Thrift Supervision and National Credit Union Administration under section 5 of the Federal Trade Commission Act (“Reg AA”) do not prohibit risk-based pricing. Reg AA only prohibits retroactive repricing of existing balances. Card issuers remain free to increase interest rates prospectively with proper notice or to protect themselves immediately by closing off credit lines.

That said, I would expect that Reg AA would likely reduce credit availability to some degree, although perhaps not to all consumers. This is not necessarily a bad outcome. Credit is a double-edged

sword. It can be a great boon that fuels economic growth, but that is only when credit does not exceed a borrower's ability to repay. Credit can also be a millstone around the neck of a borrower when it exceeds the ability to repay. Overleverage is just as bad for consumers as it is for financial institutions. To the extent that Reg AA reduces credit availability, it might be a good thing by bringing credit availability more in line with consumers' ability to repay.

Q.3. Consumer Disclosure: You state that the sheer number of price mechanisms make it difficult for consumers to accurately and easily gauge the cost of credit. You cite things such as annual fees, merchant fees, over-the-limit fees, and cash advance fees. You seem to suggest that credit cards should become much more plain vanilla because people simply can't understand the different uses and costs for those uses.

Don't these different pricing mechanisms also provide more choices for consumers as they make purchasing decisions?

A.3. That depends on the particular pricing mechanism. Many of them provide dubious choices or value for consumers. Consider over-limit fees, late fees, cash advance interest rates, and residual interest and double cycle billing.

- (1). Overlimit fees. A consumer has no right to go overlimit and cannot assume that an over-limit transaction will be allowed. Moreover, overlimit can be the result of the application of fees, rather than of purchases. Therefore, overlimit is not exactly a "choice."
- (2). A late fee is no different than interest, just applied in a lump sum. I am doubtful that most consumers would prefer an up-front lump sum late fee rather than a higher interest rate. For the large number of "sloppy payers" who pay their bills a few days late, a higher interest rate is much better than a large flat late fee, but because consumers systematically underestimate the likelihood that they will pay late, they are less concerned about the late fee than the interest rate.
- (3). Most cards charge a higher interest rate for "cash advances." A cash advance, however, is not necessarily the payment of cash to the consumer. Instead, cash advances include the use of so-called "convenience checks" that card issuers send to consumers with their billing statements. (Incidentally, convenience checks present a considerable identity theft problem because they lack cards' security features and the cardholder has no way of knowing if they have been stolen. They expose issuers to significant fraud losses and should be prohibited as an unsafe and unsound banking practice.) Convenience checks permit cardholders to use their card to pay merchants that do not accept cards, like landlords, utilities, and insurers. This allows consumers to pay these bills even when they do not have funds in their bank account. But convenience checks carry the cash advance interest rate plus a fee (often a flat 3 percent with a minimum amount). These terms are usually disclosed on the convenience checks only partially and by reference to the cardholder agreement. It is doubtful that most consumers retain their cardholder agree-

ment, so whether consumers understand the cost of using convenience checks is a dubious proposition.

- (4). Similarly, billing tricks and traps like residual interest or double cycle billing are hardly a “choice” for consumers; these are not product differentiations that are tailored to consumer preferences, as few consumers know about them, let alone understand them.

Restricting card pricing could limit innovation in the card market, but it is important to recognize that not all innovation is good. There has been very little innovation in the card industry over the last twenty years, either in terms of technology or in terms of product. Cards still operate on the same old magnetic stripe technology they had in the 1970s. The card product still performs the same basic service. To the extent there has been innovation, it has been in the business model, and it has frequently not been good for consumers. Even things like the 0 percent teaser rate are hardly unambiguous goods. While 0 percent teasers are great for consumers who can pay off the balance, they also encourage consumers to load up on credit card debt, and if there is a shock to the consumer’s income, such as a death, an illness, a divorce, or unemployment, the consumer is much more exposed than otherwise.

I recognize that it is important to protect the ability of the card industry to innovate in the future, and that is why I believe the best solution is to set a default rule that simplifies credit card pricing, but to allow a regulatory agency, such as the Federal consumer financial product safety commission proposed by Senators Durbin, Kennedy, and Schumer and Representative Delahunt (S. 566/H.R. 1705, the Financial Product Safety Commission Act of 2009) to have the power to card issuers to introduce new products and product features provided that they meet regulatory consumer safety standards.

Q.4. Bankruptcy Filings: As the recession worsens, many American families will likely rely on credit cards to bridge the gap for many of their consumer finance needs. Mr. Levitin and Mr. Zywicki, you seem to have contrasting points of view on whether credit cards actually force more consumers into bankruptcy, or whether credit cards help consumers avoid bankruptcy.

Could both of you briefly explain whether the newly enacted credit card rules will help consumers avoid bankruptcy or push more consumers into bankruptcy?

A.4. The newly enacted Federal Reserve credit card regulations will not have any impact on bankruptcy filings presently, as they do not go into effect until summer of 2010. When they do go into effect, their impact on consumer bankruptcy filings will likely be mixed.

Credit card debt has a stronger correlation with bankruptcy filings than other types of debt. But this is not necessarily a function of credit card billing practices. Card debt reflects the macroeconomic problems of the American family—rising costs of health care, education, and housing but stagnant wages and depleted savings. The card billing tricks and traps targeted by the Fed’s rules amplify this distress, but the Fed’s rules will not solve the fundamental problems of the American family. To the extent that they

limit the amplifying effect that card billing tricks and traps have on card debt levels, it will help some consumers avoid bankruptcy.

If the rules result in contraction of credit availability, it might push consumers into bankruptcy, but that would have to be netted out against the number that are helped by a reduction in the amplification effect, and I am skeptical that there would be much contraction.

I agree with Professor Zywicki that credit cards can help some consumers avoid bankruptcy. If a consumer has a temporary setback in income, credit cards can provide the consumer with enough funds to hang on until their financial situation reverses. But credit cards can also exacerbate financial difficulties, and even if the consumer's fortunes pick up, it might be impossible to service the card debt. Moreover, there are many consumers whose financial situations are not going to pick up, and for these consumers, card debt just adds to their distress.

Q.5. Safety and Soundness and Consumer Protection: I believe firmly that safety and soundness and consumer protection go hand-in-hand. One needs only to look at the disaster in our mortgage markets, for clear evidence of what happens when regulators and lenders divorce these two concepts. A prudent loan is one where the financial institution fully believes that the consumer has a reasonable ability to repay.

Do you agree that prudential regulation and consumer protection should both be rigorously pursued together by regulators?

A.5. Yes, but not by the same regulators. There is an essential conflict between safety-and-soundness and consumer protection. A financial institution can only be safe and sound if it is profitable. And abusive and predatory lending practices can often be extremely profitable, especially in the short term, and can compensate for the lender's other less profitable activities. The experience of the past decade shows that when Federal regulators like the Office of Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Reserve are charged with both safety-and-soundness and consumer protection, they inevitably (and perhaps rightly) favor safety-and-soundness at the expense of consumer protection. These functions cannot coexist in the same agency, and consumer protection responsibilities for financial products should be shifted to a single independent Federal agency (which would not claim preemptive authority over state consumer protection actions) to protect consumer protection.

Q.6. Subsidization of High-Risk Customers: I have been receiving letters and calls from constituents of mine who have seen the interest rates on their credit cards rise sharply in recent weeks. Many of these people have not missed payments. Mr. Clayton, in your testimony you note that credit card lenders have increased interest rates across the board and lowered credit lines for many consumers, including low-risk customers who have never missed a payment.

Why are banks raising interest rates and limiting credit apparently so arbitrarily?

A.6. Banks are raising interest rates on consumers and limiting credit to cover for their own inability to appropriately price for risk

in mortgage, securities, and derivatives markets has resulted in their solvency being threatened. Therefore, banks are trying to limit their credit card exposures and are trying to increase revenue from credit card accounts by raising rates. If banks are unable to competently price for risk for mortgages, where there is often robust underwriting, what confidence should we have in their ability to price for risk for credit cards where every loan is a stated income “liar” loan? The current financial debacle should cause us to seriously question banks’ claims of risk-based pricing for credit cards. The original pricing failed to properly account for risk and the new arbitrary repricing certainly fails to account for risk on an individualized level. The only risk being reflected in the new pricing is the bank’s default risk, not the consumer’s.

Does this result in low-risk customers subsidizing people who are high-risk due to a track record of high-risk behavior?

Yes, it probably does because it is being done so arbitrarily.

Q.7. Effects on Low-income Consumers: I want to put forward a scenario for the witnesses. Suppose a credit card customer has a low income and a low credit limit, but a strong credit history. They use their credit card for unexpected expenses and pay it off as soon as possible, never incurring late fees. With the new regulations approved by the Federal Reserve, banks will be restricted in their use of risk-based pricing. This means our cardholder could see his or her interest rates and fees increased to pay for the actions of other card holders, many of whom have higher incomes.

Do any of the witnesses have concerns that moving away from risk-based pricing could result in the subsidization of credit to wealthy yet riskier borrowers, by poorer but lower-risk borrowers?

A.7. No. The issue is a red-herring. As an initial matter, it is important to emphasize that the Federal Reserve’s new regulations do not prohibit risk-based pricing. They only prohibit retroactive repricing of existing balances. In other words, they say that card issuers only get one bit at the risk pricing apple, just like any normal contract counterparty. Card issuers remain free to price however they want prospectively or to reduce or cutoff credit lines if they are concerned about risk.

Second, it is important to underscore that to the extent that card issuers engage in risk-based pricing, it is only a small component of the cost of credit. I discuss this at length in my written testimony, but I will note that Professor Zywicki has himself written that 87 percent of the cost of credit cards has nothing to do with consumer risk; it is entirely a function of the cost of operations and the cost of funds. Todd J. Zywicki, *The Economics of Credit Cards*, 3 CHAP. L. REV. 79, 121 (2000). The remaining 13 percent represents both a risk premium and opportunity pricing. In many cases the opportunity-pricing component predominates. Therefore, there to the extent that credit card issuers do risk based pricing, it only has a marginal impact on the total cost of cards. As Professor Ausubel demonstrated in his written and oral testimony, a significant component of some credit card fees, like late fees, are opportunity costs. Likewise, in my written testimony, the section comparing my own credit cards, three of which are from the same issuer, but which have different rates that do not correspond with

credit limits, indicates that there is significant opportunity pricing in the card market. Regulations that make cards fairer and more transparent would be unlikely to have much impact on consumer pricing.

Third, it is not clear why cross subsidization should be a particular concern. It is a common fact of life. Consider flat-fee parking lots. Those consumers who park for 5 minutes subsidize those who park for hours. Similarly, at by-the-pound salad bars, consumers who eat only carrots subsidize those who eat only truffles. When cross-subsidization is regressive, it elicits additional concerns, but there are far more serious regressive price structures, not the least of which is the Internal Revenue Code.

That said, I believe the cross-subsidization in the scenario to be unlikely because the risk that matters to card issuers is non-payment risk, not late payment risk, and income and wealth generally correlate with low nonpayment risk. In sum, then, I think the cross-subsidization scenario presented is unlikely, and to the extent it occurs, the cross-subsidization will only be *de minimis* because of the limited extent of risk-based pricing. The problem presented by the scenario is a red herring concern and not a reason to shy away from regulating credit cards.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY
FROM KENNETH J. CLAYTON**

Q.1. Access to Credit: A potential outcome of the new rules could be that consumers with less than a 620 FICO score could be denied access to a credit card. Such an exclusion could affect 45.5 million individuals or over 20 percent of the U.S. population.

Without access to traditional credit, where do you believe that individuals would turn to finance their consumer needs?

A.1. It is likely that consumers perceived to have higher levels of risk—including those that are new to credit—will bear the brunt of credit reductions resulting from the rule. Thus, as noted in your question, the inability to price risk effectively may well mean less access to credit for very deserving individuals just because card issuers are unsure of the credit risk involved and will not be able to price for that risk as it becomes more apparent. As the credit needs of these individuals are unlikely to disappear—and, in fact, may actually increase due to exigent economic circumstances, *e.g.*, unemployment—these consumers will likely be forced to turn to non-federally regulated lenders including payday lenders and loan sharks.

Q.2. Risk-Based Pricing: Banks need to make judgments about the credit-worthiness of consumers and then price the risk accordingly. Credit cards differ from closed-end consumer transactions, such as mortgages or car loans, because the relationship is ongoing. I am concerned by the Federal Reserve's new rules on risk-based repricing for a couple of reasons. First, without the ability to price for risks, banks will be forced to treat everyone with equally stringent terms, even though many of these individuals perform quite differently over time. Second, without a mechanism to reprice according to risk as a consumer's risk profile changes, many lenders

will simply refuse to extend credit to a large portion of the population.

Do you believe that consumers will have access to less credit and fewer choices because of the Fed's new rule? If so, is this a desirable outcome?

A.2. The new rule will affect every aspect of the credit card business, from how cards are funded, to how they are priced, to how they are marketed, and to how credit is allocated among customers of differing credit histories and risk. Because the rules are so strong, card lenders may have to increase interest rates in general, lower credit lines, assess more annual fees, and reduce credit options for some customers. The full impact of these changes will likely not be fully known for several years as business practices are changed and as the credit availability works its way through the economy.

The new rule may also lead to higher interest rates or fees (such as annual fees) for all cardholders in order to compensate for the inability to price risk effectively. Thus, the least risky borrowers must now bear the cost for higher risk borrowers because the higher-risk borrowers will no longer bear the full cost of the exposure they pose to lenders. It may also be the case that payment allocation requirements will lead to the elimination of low-rate balance transfers that consumers and small businesses previously used to lower overall debt costs. Simply put, the sum total of all these rules will likely lead to reduced access to credit and higher prices to all consumers, in addition to many fewer choices on card products. We do not believe this is a desirable outcome for both consumers and the broader economy.

Q.3. Safety and Soundness and Consumer Protection: I believe firmly that safety and soundness and consumer protection go hand-in-hand. One needs only to look at the disaster in our mortgage markets, for clear evidence of what happens when regulators and lenders divorce these two concepts. A prudent loan is one where the financial institution fully believes that the consumer has a reasonable ability to repay.

Do you agree that prudential regulation and consumer protection should both be rigorously pursued together by regulators?

A.3. A system linking bank regulation and consumer protection forces more balanced supervision without the turf battles and inefficiency inherent in bifurcated jurisdiction. The two are highly integrated, and that one aspect cannot and should not be divorced from the other. This ensures that, for example, safe and sound lending would not be compromised by fee and rate restrictions envisioned by a consumer regulator only concerned with driving consumer costs down unencumbered by a need to consider the impact such restrictions may have on adequate return.

Q.4. Subsidization of High-Risk Customers: I have been receiving letters and calls from constituents of mine who have seen the interest rates on their credit cards rise sharply in recent weeks. Many of these people have not missed payments. Mr. Clayton, in your testimony you note that credit card lenders have increased interest rates across the board and lowered credit lines for many con-

sumers, including low-risk customers who have never missed a payment.

Why are banks raising interest rates and limiting credit apparently so arbitrarily?

Does this result in low-risk customers subsidizing people who are high-risk due to a track record of high-risk behavior?

A.4. The rising interest rates and limitations on credit are due primarily to three factors. First, in the present challenging economic time, lenders are being more careful. Delinquencies on credit card accounts have significantly increased as a result of rising unemployment and uncertainty in the economy. This substantial increase in repayment risk affects the ability of lenders to make new loans, and requires companies to carefully evaluate and minimize their risk across the board so that they may stay in business and continue to make new loans.

Second, funding costs have increased dramatically in the secondary market, which funds nearly half (or approximately \$450 billion) of all credit card loans made by commercial banks. Investors are extremely sensitive to changes in the terms and conditions of the underlying asset, as has been evident in the current market, where investors have shunned nearly all forms of asset-backed securities over fears in the underlying economy. This drives up the cost of funding new credit, and leads to higher costs to consumers.

Third, all businesses are concerned for the future, as borrowers' ability to repay may become severely compromised. This is particularly true with respect to credit card loans, which are open-end lines of credit, unsecured and greatly subject to changing risk profiles of borrowers. Banks need to ensure they will be paid for the risks they have taken in credit card loans; otherwise they will not be able to continue to make loans. As a result, many institutions must raise rates and reduce risk exposure in order to continue to lend. This results in all borrowers having to bear the cost of higher risk generally, a trend that will be exacerbated by the new regulations that limit the ability of lenders to price particular individuals for the risk they pose.

Q.5. Effects on Low-income Consumers: I want to put forward a scenario for the witnesses. Suppose a credit card customer has a low income and a low credit limit, but a strong credit history. They use their credit card for unexpected expenses and pay it off as soon as possible, never incurring late fees. With the new regulations approved by the Federal Reserve, banks will be restricted in their use of risk-based pricing. This means our cardholder could see his or her interest rates and fees increased to pay for the actions of other card holders, many of whom have higher incomes.

Do any of the witnesses have concerns that moving away from risk-based pricing could result in the subsidization of credit to wealthy yet riskier borrowers, by poorer but lower-risk borrowers?

A.5. Reducing the ability of lenders to manage risk forces them to apply more general models to all account holders. The consequence of applying general models is that all account holders pay somewhat equally. Lower-risk borrowers at all income levels bear the brunt of this burden.

Q.6. Role of Securitization: It is my understanding that during the height of the credit boom nearly half of all credit card debt outstanding was held in securitization trusts. Over the last 18 months much of the securitization market has been severely constrained. The Federal Reserve wants to revive the securitization markets through the Term Asset Lending Facility (TALF), but it is not yet operational.

How important is a rebound in the securitization market to the availability of consumer credit? In other words, how much greater will the contraction be in the credit card space without securitization?

A.6. The rebound in the securitization market is a critical component to the availability of credit in our economy. Credit cards are funded from two primary sources: deposits and secondary market funding, each accounting for about half—approximately \$0.5 trillion dollars—of the total funding of card loans to consumers. Funding in the secondary market relies on investors' willingness to hold securities that are backed by credit card receivables. Any change in the terms of issuance can greatly impact the receptivity of investors to holding these securities. If investors perceive that there is greater risk, they are less likely to hold these securities, or may require significantly higher interest rates or other enhancements to compensate them for the risk. This means that less funding will be available, and if available, more costly. This translates into less credit available at higher cost to customers. It is hard to speculate as to the extent of greater contraction caused by a non-functioning securitization market, as lenders will have to turn to a limited number of alternative—and higher priced—funding mechanisms. However, we do believe the additional contraction would be very significant, and is reflected in the Administration's concern over this important aspect of the marketplace.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY
FROM JAMES C. STURDEVANT**

Q.1. Access to Credit: A potential outcome of the new rules could be that consumers with less than a 620 FICO score could be denied access to a credit card. Such an exclusion could affect 45.5 million individuals or over 20 percent of the U.S. population.

Without access to traditional credit, where do you believe that individuals would turn to finance their consumer needs?

A.1. Did not respond by publication deadline.

Q.2. Risk-Based Pricing: Banks need to make judgments about the credit-worthiness of consumers and then price the risk accordingly. Credit cards differ from closed-end consumer transactions, such as mortgages or car loans, because the relationship is ongoing. I am concerned by the Federal Reserve's new rules on risk-based repricing for a couple of reasons. First, without the ability to price for risks, banks will be forced to treat everyone with equally stringent terms, even though many of these individuals perform quite differently over time. Second, without a mechanism to reprice according to risk as a consumer's risk profile changes, many lenders

will simply refuse to extend credit to a large portion of the population.

Do you believe that consumers will have access to less credit and fewer choices because of the Fed's new rule? If so, is this a desirable outcome?

A.2. Did not respond by publication deadline.

Q.3. Safety and Soundness and Consumer Protection: I believe firmly that safety and soundness and consumer protection go hand-in-hand. One needs only to look at the disaster in our mortgage markets, for clear evidence of what happens when regulators and lenders divorce these two concepts. A prudent loan is one where the financial institution fully believes that the consumer has a reasonable ability to repay.

Do you agree that prudential regulation and consumer protection should both be rigorously pursued together by regulators?

A.3. Did not respond by publication deadline.

Q.4. Subsidization of High-Risk Customers: I have been receiving letters and calls from constituents of mine who have seen the interest rates on their credit cards rise sharply in recent weeks. Many of these people have not missed payments. Mr. Clayton, in your testimony you note that credit card lenders have increased interest rates across the board and lowered credit lines for many consumers, including low-risk customers who have never missed a payment.

Why are banks raising interest rates and limiting credit apparently so arbitrarily?

Does this result in low-risk customers subsidizing people who are high-risk due to a track record of high-risk behavior?

A.4. Did not respond by publication deadline.

Q.5. Effects on Low-income Consumers: I want to put forward a scenario for the witnesses. Suppose a credit card customer has a low income and a low credit limit, but a strong credit history. They use their credit card for unexpected expenses and pay it off as soon as possible, never incurring late fees. With the new regulations approved by the Federal Reserve, banks will be restricted in their use of risk-based pricing. This means our cardholder could see his or her interest rates and fees increased to pay for the actions of other card holders, many of whom have higher incomes.

Do any of the witnesses have concerns that moving away from risk-based pricing could result in the subsidization of credit to wealthy yet riskier borrowers, by poorer but lower-risk borrowers?

A.5. Did not respond by publication deadline.

Q.6. Transactional Users vs. Revolving Users: Mr. Zywicki has said in previous Congressional testimony that prior pricing mechanisms—which relied to a large degree on annual fees—forced transactional users of credit cards to subsidize the actions of consumers who carry revolving debts. I do not believe that the two categories should be treated in the same manner. The new regulations seem to limit the ability of lenders to use tools to distinguish between the borrowers characteristics.

Do you believe that borrowers' rates and fees should be determined based on their own actions and not on those of others?

Do you think that credit card offerings from the past, which had high APR's and annual fees for all customers were more consumer friendly than recent offerings that use other tools to determine fees and interest rates?

A.6. Did not respond by publication deadline.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY
FROM TODD ZYWICKI**

Q.1. Access to Credit: A potential outcome of the new rules could be that consumers with less than a 620 FICO score could be denied access to a credit card. Such an exclusion could affect 45.5 million individuals or over 20 percent of the U.S. population.

Without access to traditional credit, where do you believe that individuals would turn to finance their consumer needs?

A.1. This is the most worrisome aspect of well-intentioned consumer credit regulations that will have unintended consequences of driving borrowers, especially credit-impaired borrowers, to other less-attractive forms of credit. Those who are unable to get a credit card will likely be forced to turn to alternatives such as payday lending. Those unable to get credit from a payday lender will likely be forced to turn to pawn shops. And those who are unable to gain access to pawn shop credit may find themselves unable to get legal credit at all.

Consumers often have emergencies or necessities for which they need credit. For instance, a young person needs credit to start a life away from home—clothes for a job, furniture for an apartment, *etc.* Consumers may have emergencies such as car repairs, for which they will have to find credit somewhere. If good credit is not available consumers will turn toward less-attractive terms of credit instead.

Q.2. Benefits of Credit Card Use: Professor Zywicki, in previous testimony you suggested growth in credit cards as a source of consumer credit has replaced installment lending, pawnshops, and payday lending. I am concerned that the newly finalized rules may result in a lack of available consumer credit. I believe that there were clearly some egregious practices that the Federal Reserve and others should appropriately eliminate, but many who have criticized the credit card industry for facilitating excessive consumer debt, fail to point out the benefits of open access to consumer credit.

Does the consumer benefit from access to open ended consumer credit over other less regulated forms of credit such as pawn shops, payday lenders, and installment lending?

A.2. Consumers absolutely benefit from access to open-ended consumer credit. The dramatic growth in credit card use in recent decades testifies to this fact. Installment lending, such as retail store credit is limited because it requires consumers to "buy" goods and credit as a bundle. Personal finance company loans are typically both more expensive for the buyer to apply for, offer higher interest rates and other costs, and impose a rigid repayment schedule. A

borrower also might be unable to get a personal finance company loan at the moment that he needs it. Payday lending and pawnshops are obviously inferior to credit cards and these other options.

Credit cards offer consumers many benefits that these other products do not. Credit cards have flexible use and repayment terms. Borrowers can pay as much as they want and can switch easily among alternative card issuers. They are also generally acceptable, thereby allowing the unhooking of the credit transaction from the goods transaction. This allows consumers to shop more vigorously in both markets. General-acceptance credit cards also permit small businesses to compete on an equal footing with large businesses and department stores by relieving those small businesses of the risk and cost of maintaining their own in-house credit operations. According to one survey conducted by the Federal Reserve, 73 percent of consumers report that the option to revolve balances on their credit cards makes it “easier” to manage their finances versus only 10 percent who said this made it “more difficult.” Durkin, *Credit Cards: Use and Consumer Attitudes* at 623.

Q.3. Risk-Based Pricing: Banks need to make judgments about the credit-worthiness of consumers and then price the risk accordingly. Credit cards differ from closed-end consumer transactions, such as mortgages or car loans, because the relationship is ongoing. I am concerned by the Federal Reserve’s new rules on risk-based repricing for a couple of reasons. First, without the ability to price for risks, banks will be forced to treat everyone with equally stringent terms, even though many of these individuals perform quite differently over time. Second, without a mechanism to reprice according to risk as a consumer’s risk profile changes, many lenders will simply refuse to extend credit to a large portion of the population.

Do you believe that consumers will have access to less credit and fewer choices because of the Fed’s new rule? If so, is this a desirable outcome?

A.3. This is likely to be the case, for exactly the reasons stated. If lenders are permitted only to reduce interest rates but not raise them, they will have to charge a higher interest rate to all borrowers to compensate for this risk. Moreover, this would give borrowers an opportunity to reduce their interest rates by switching to another card but lenders would be unable to raise interest rates in response to a change in the borrowers risk profile.

Credit cards are structured as revolving debt for a reason: unlike other loans, it amounts to a new loan every month. Thus, every month the borrower has the option to switch to another, lower-interest card.

Q.4. Bankruptcy Filings: As the recession worsens, many American families will likely rely on credit cards to bridge the gap for many of their consumer finance needs. Mr. Levitin and Mr. Zywicki, you seem to have contrasting points of view on whether credit cards actually force more consumers into bankruptcy, or whether credit cards help consumers avoid bankruptcy.

Could both of you briefly explain whether the newly enacted credit card rules will help consumers avoid bankruptcy or push more consumers into bankruptcy?

A.4. By making credit cards less-available and less-flexible, new stringent regulations will likely push more consumers into bankruptcy. Consumers in need of credit will seek that credit somewhere. Reducing access to good credit, like credit cards, will force these borrowers into the hands of much higher-cost credit, such as payday lenders. Moreover, credit cards are especially valuable because they provide a line of credit that the borrower can access when he needs it, such as when he loses his job and has medical bills. By contrast, if the borrower is required to apply for a bank loan after a job loss, he is likely to be rejected, which will accelerate his downward spiral. Moreover, credit cards are valuable in that they can be used to purchase almost any good or service. Again, the flexibility of credit cards is valuable to consumers.

Q.5. Safety and Soundness and Consumer Protection: I believe firmly that safety and soundness and consumer protection go hand-in-hand. One needs only to look at the disaster in our mortgage markets, for clear evidence of what happens when regulators and lenders divorce these two concepts. A prudent loan is one where the financial institution fully believes that the consumer has a reasonable ability to repay.

Do you agree that prudential regulation and consumer protection should both be rigorously pursued together by regulators?

A.5. Yes. But not all safety and soundness issues related to consumers are also consumer protection issues. For instance, there were obviously a number of ordinary homeowners who essentially decided to act like investors with respect to their homes by taking out nothing-down, no-interest mortgages and then walking away when those homes fell into negative equity. If the consumers failed to understand the terms of those mortgages, then that is a consumer protection issue. If, however, the consumer consciously made this choice to speculate and the lender made the loan anyway, then while this would trigger a safety and soundness concern it is difficult to see how this would amount to a consumer protection issue.

Q.6. Subsidization of High-Risk Customers: I have been receiving letters and calls from constituents of mine who have seen the interest rates on their credit cards rise sharply in recent weeks. Many of these people have not missed payments. Mr. Clayton, in your testimony you note that credit card lenders have increased interest rates across the board and lowered credit lines for many consumers, including low-risk customers who have never missed a payment.

Why are banks raising interest rates and limiting credit apparently so arbitrarily?

Does this result in low-risk customers subsidizing people who are high-risk due to a track record of high-risk behavior?

A.6. Did not respond by publication deadline.

Q.7. Effects on Low-income Consumers: I want to put forward a scenario for the witnesses. Suppose a credit card customer has a low income and a low credit limit, but a strong credit history. They use their credit card for unexpected expenses and pay it off as soon as possible, never incurring late fees. With the new regulations approved by the Federal Reserve, banks will be restricted in their use

of risk-based pricing. This means our cardholder could see his or her interest rates and fees increased to pay for the actions of other card holders, many of whom have higher incomes.

Do any of the witnesses have concerns that moving away from risk-based pricing could result in the subsidization of credit to wealthy yet riskier borrowers, by poorer but lower-risk borrowers?

A.7. Interference with risk-based pricing makes it more difficult for lenders to tailor prices to the details of the behavior of particular consumers. As a result, lenders have to price card terms on less fine-grained assessments of risk. This leads to pricing risk across broader categories of borrowers, and in turn, increases the cross-subsidization among consumers. I can see no good policy reason why this should be encouraged.

Q.8. Restriction on Access to Credit: One suggestion being made in order to encourage students not to become overly dependent on debt is to restrict access to credit to individuals under the age of 21.

Mr. Zywicki, could you explain for the Committee the potential benefits and detriments of this policy?

A.8. Benefit: A potential benefit, in theory, is that some younger consumers may avoid getting into debt trouble. I am not aware of any rigorous empirical evidence of how common this is.

Detriments: There are several detriments:

- (1) Students who do not have access to credit cards may be tempted to take out more in the way of student loans. Because repayment on student loans is deferred until after graduation, this could cause students to take on more debt than they would if they had to pay some of their balance every month.
- (2) Empirical studies find that one major reason that causes students to drop out of college is a lack of access to credit. Many students eventually tire of "living like a student," *i.e.*, living in dorms and eating dorm food and Ramen noodles. They want an opportunity to have some sort of normal life, to go out to dinner every once in a while. Many students use credit responsibly and maturely and can have a happier student life experience if they have access to a credit card.
- (3) Many students need access to credit. Although under the age of 21, many students essentially live on their own in off-campus apartments and the like. They need credit cards to pay for food, transportation, and the like. Thus, the rule sweeps far too broadly.
- (4) Since the early 1990s, the fastest-rising debt on household balance sheets has been student loan debt. Students routinely graduate with tens of thousands of dollars in student loan debt. By contrast, very few students have more than a few thousand dollars in credit card debt. If Congress wants to seriously help indebted students, it should investigate the extraordinary level of student loan debt being accumulated. While credit cards can be a problem in some cases, the scope of the problem is dwarfed by the deluge of student loan debt.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY
FROM LAWRENCE M. AUSUBEL**

Q.1. Access to Credit: A potential outcome of the new rules could be that consumers with less than a 620 FICO score could be denied access to a credit card. Such an exclusion could affect 45.5 million individuals or over 20 percent of the U.S. population.

Without access to traditional credit, where do you believe that individuals would turn to finance their consumer needs?

A.1. There is no reason to expect that the new rules will result in the wholesale denial of access to credit cards for any group of consumers that currently has access to credit cards. As such, individuals who currently have access to credit cards are likely to continue to rely primarily on credit cards for their consumer finance needs.

Q.2. Risk-Based Pricing: Banks need to make judgments about the credit-worthiness of consumers and then price the risk accordingly. Credit cards differ from closed-end consumer transactions, such as mortgages or car loans, because the relationship is ongoing. I am concerned by the Federal Reserve's new rules on risk-based repricing for a couple of reasons. First, without the ability to price for risks, banks will be forced to treat everyone with equally stringent terms, even though many of these individuals perform quite differently over time. Second, without a mechanism to reprice according to risk as a consumer's risk profile changes, many lenders will simply refuse to extend credit to a large portion of the population.

Do you believe that consumers will have access to less credit and fewer choices because of the Fed's new rule? If so, is this a desirable outcome?

A.2. There is no reason to expect that consumers will have significantly less access to credit or fewer choices because of the Fed's new rule. The principal effect of the new rule will be to limit penalty pricing of credit card consumers, not to limit access to credit or consumer choices.

Q.3. Safety and Soundness and Consumer Protection: I believe firmly that safety and soundness and consumer protection go hand-in-hand. One needs only to look at the disaster in our mortgage markets, for clear evidence of what happens when regulators and lenders divorce these two concepts. A prudent loan is one where the financial institution fully believes that the consumer has a reasonable ability to repay.

Do you agree that prudential regulation and consumer protection should both be rigorously pursued together by regulators?

A.3. It should be observed that consumer protection, as furthered by the Dodd bill, will help to contribute to the prudence of loans. Consumers will better understand whether they will be able to repay loans, and they will be more likely to avoid loans that they understand they do not have the reasonable ability to repay. Lenders will be unable to rely on penalty interest rates following delinquency, so they will be more likely to avoid making loans that are destined to go delinquent. It is difficult to state an opinion on pru-

dential regulation more generally, without being provided some specificity about the form of prudential regulation being proposed.

Q.4. Subsidization of High-Risk Customers: I have been receiving letters and calls from constituents of mine who have seen the interest rates on their credit cards rise sharply in recent weeks. Many of these people have not missed payments. Mr. Clayton, in your testimony you note that credit card lenders have increased interest rates across the board and lowered credit lines for many consumers, including low-risk customers who have never missed a payment.

Why are banks raising interest rates and limiting credit apparently so arbitrarily?

Does this result in low-risk customers subsidizing people who are high-risk due to a track record of high-risk behavior?

A.4. If it is the case that banks are raising interest rates and limiting credit arbitrarily, this is probably due primarily to the financial crisis and the economic downturn. Under normal circumstances, credit card lending is highly profitable and there is little reason for banks to reduce credit lines. Banks do raise interest rates, but usually not across the board, as this would result in the loss of some profitable customers. There is no reason to expect that the new rules will lead to cross-subsidization of any particular group of customers.

Q.5. Effects on Low-income Consumers: I want to put forward a scenario for the witnesses. Suppose a credit card customer has a low income and a low credit limit, but a strong credit history. They use their credit card for unexpected expenses and pay it off as soon as possible, never incurring late fees. With the new regulations approved by the Federal Reserve, banks will be restricted in their use of risk-based pricing. This means our cardholder could see his or her interest rates and fees increased to pay for the actions of other card holders, many of whom have higher incomes.

Do any of the witnesses have concerns that moving away from risk-based pricing could result in the subsidization of credit to wealthy yet riskier borrowers, by poorer but lower-risk borrowers?

A.5. No. There is no reason to expect that the new rules will lead to cross-subsidization of any particular group of customers. The principal effect of the new rules will be to limit increases in credit card interest rates following late payments. As documented in my written testimony, the typical increases in interest rates bear no reasonable relation to default risk. The penalties imposed on consumers are typically at least double or triple the enhanced credit losses attributable to these consumers. The terminology of “risk-based pricing” for the regulated practices is a misnomer; it is more accurately viewed as “penalty pricing.” Under the new rules, banks will still be able to charge higher interest rates (upfront) to riskier customers. That is, true risk-based pricing will still be possible within the rules.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY
FROM TRAVIS PLUNKETT**

Q.1. Without access to traditional credit, where do you believe that individuals would turn to finance their consumer needs?

A.1. As I mentioned in my testimony before the Committee, it is important to note that the lack of regulation can also lead to detrimental market conditions that ultimately limit access to credit for those with less-than-perfect credit histories. Credit card issuers have recently reduced the amount of credit they offer to both existing and new cardholders, for reasons that have virtually nothing to do with pending regulation of the market. Issuers' losses have been increasing sharply, in part because of unsustainable lending practices. (Please see my written testimony for more information.) Had Congress stepped in earlier to require issuers to exercise more responsible lending, they might not be cutting back on available credit as sharply right now.

Regarding access to affordable credit for individuals with an impaired or limited credit history, CFA has urged mainstream financial institutions to offer responsible small loan products to their depositors. We applaud FDIC Chairman Sheila Bair's leadership in proposing guidelines for responsible small loans and her call for military banks to develop products that meet the test of the Military Lending Act predatory lending protections. Banks and credit unions should extend their line of credit overdraft protection to more account holders. The FDIC has a pilot project with 31 participating banks making loans under the FDIC guidelines for responsible small-dollar lending.

Offering affordable credit products is not the only strategy needed to help households more effectively deal with a financial shortfall. Borrower surveys reveal that many households are not using high-cost credit because of a single financial emergency, but instead have expenses that regularly exceed their income. For these households who may not be able to financially handle additional debt burdens at any interest rate, non-credit strategies may be more appropriate. These may include budget and financial counseling; getting help from friends, family, or an employer; negotiating with a creditor; setting up different bill payment dates that better align with the person's pay cycle; and putting off a purchase for a few days.

Toward this end, it is very important that banks and credit unions encourage make emergency savings easy and attractive for their low- and moderate-income customers. Emergency savings are essential to keep low-income consumers out of the clutches of high-cost lenders. CFA's analysis based on Federal Reserve Board and other survey data found that families earning \$25,000 per year with no emergency savings were eight times as likely to use payday loans as families in the same income bracket who had more than \$500 in emergency savings. We urge banks and credit unions to make emergency savings easy and attractive for their customers.

Q.2. Do you agree that prudential regulation and consumer protection should both be rigorously pursued together by regulators?

A.2. Absolutely. Credit card issuers must do a better job of ensuring that borrowers truly have the ability to repay the loans they

are offered. As I mention in my testimony, card issuers and card holders would not be in as much financial trouble right now if issuers had done a better job of assessing ability to repay. This is why CFA has supported legislation that would require issuers to more carefully assess the repayment capacity of young borrowers and potential cardholders of all ages.

Q.3. Do any of the witnesses have concerns that moving away from risk-based pricing could result in the subsidization of credit to wealthy yet riskier borrowers, by poorer but lower-risk borrowers?

A.3. Under the Federal Reserve rules, card issuers will certainly have to be more careful about who they extend credit to and how much credit they offer. Given the current levels of indebtedness of many card holders—and the financial problems this indebtedness has caused these borrowers and card issuers—it is hard to argue that this is a bad thing. However, the Federal Reserve rules still preserve the ability of card issuers to price for risk in many circumstances, if they wish. They can set the initial rate a cardholder is offered based on perceived financial risk, reprice on a cardholder's existing balance if the borrower is late in paying a bill by more than 30 days, and change the borrower's prospective interest rate for virtually any reason, including a minor drop in the borrower's credit score or a problem the borrower has in paying off another debt. In addition, issuers can manage credit risk in more responsible ways by reducing borrowers' credit lines and limiting new offers of credit.

Q.4. Do you believe that borrowers' rates and fees should be determined based on their own actions and not on those of others?

A.4. It is certainly reasonable to base offers of credit on legitimate assessments of borrowers' credit worthiness. As I mention in my testimony, however, many of the pricing methods that card issuers have used to arbitrarily increase borrowers' interest rates and fees do not appear to be based on true credit risk, but rather on the judgment of issuers that they can get away with charging what the market will bear.

Q.5. Do you think that credit card offerings from the past, which had high APR's and annual fees for all customers were more consumer friendly than recent offerings that use other tools to determine fees and interest rates.

A.5. As I mention in my response above, the Federal Reserve rules leave plenty of room for card issuers to price according to borrower's risk, so I do not think it is likely that we will see a return to the uniform, undifferentiated pricing policies of the past.